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Improving Property Rights Protection: Problem Structure, Indicators, Action Directions

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Introduction

The RF Government's scope of objectives¹ includes "Guaranteeing Property Rights' Protection" (Objective 2.2.6.). At the same time, as is seen from the analysis of available Budget Reports provided by the budget planning subjects neither of them except for Federal Service for Financial Markets indicated the above objective of the RF Government within the scope of their assigned strategic objectives deemed conducive to the progress of the budget planning subject (BPS) in question.

One of the possible reasons for that is **inadequate structuring of the problem** of property rights protection in general and private property rights in particular, lack of clarity as regards **quantification** of the level of property rights protection and a "**what-to-do**" visioning, i.e., action plans to achieve the above objective set forth by the RF Government.

In consideration of the above, this analytical paper contains materials aimed at clarifying the above issues. Along with **proposals, recommendations and findings** it comprises **references and definitions** whose inclusion herein is prompted by a comparative **novelty of the theoretical conceptions** in the area of economics that have made up a **methodological basis** for the above proposals, findings and recommendations.

Part I contains recommendations on the subject;

Part II contains a summary of theoretical conceptions and analytical tools that helped to deliver the results presented in Section I.

¹ Guidelines for drafting Reports on Progress Made and Action Plans of Key Budget Planning Subjects (BPS). Appendix # 1. Tentative list of strategic objectives for drafting Reports on Progress Made and Action Plans of Key Budget Planning Subjects.

1. Recommendations on Reflecting Actions for Property Rights Protection Improvement in BPS Activities and Reports

A problem of insufficient *validation of proprietorship relations* as defined in the earlier mentioned request may in the terms of the modern economics be redefined as **poor specification and protection of property rights**². Henceforth, it will be analyzed in the above definition.

1.1. Problem structure

Transition from the current situation with property rights to various types of assets to a situation where owners will have viable incentives to effectively use his assets *mean* that the following steps be taken:

- ⇒ Secure clear specification of property rights;
- ⇒ Secure property rights protection to assets in the proprietor's ownership;
- ⇒ Secure property rights protection in the event of legal transfer;
- ⇒ Secure effective reinstatement of the violated property rights.

Specification, protection and reinstatement of property rights are the responsibility of a social subject which is called a *guarantor* of the property right. Various individuals, their associations, organizations and associations of organizations may assume functions and act in the capacity of a guarantor.

Specification of the property rights means:

- ➔ Specify property items (assets) qualifying under this or that property right;
- ➔ Specify the scope of a property right in question;
- ➔ Specify a subject (holder) of the property right;
- ➔ Specify degree of exclusivity of the property right.

Each of the above procedures represents a relatively complex set of activities:

To specify the *object* of a property right means to describe material characteristics of the underlying asset reflecting its "natural" properties (including but not limited to date of generation, location, the asset's scope and scale) so that whenever a conflict arises it may unambiguously be defined which asset is referred to.

To specify the *scope* of the property right means to ascertain *what specifically* the owner *may do* with an asset in question without running the risk of being penalized by the guarantor. In other words ascertainment of the scope of the property right to a particular asset means to define a set of entitlements (i.e., "bundle of rights") which corresponds to a multitude of permissible solutions that might be applied by the holder of a particular right.

To specify the *holder* of a property right means to ascertain an individual or an organization that is to be vested with a property right the scope of which is specified at the previous stage.

² For stricter definitions employed herein see Part II, Sections 2.1 and 2.2.

Specify the *degree of exclusivity* of a property right means to ascertain to what extent the right may be exercised by its holder *without any consent whatsoever* from other individuals or legal entities.

To protect the holder's property right to a particular asset means *to prevent the use of this asset in a manner and for purposes not authorized by the latter's holder* by other holders (potential infringers), including:

- ➔ Individuals;
- ➔ Legal entities;
- ➔ The State, its agencies and organizations and individual public officers.

Protection of the property right against each of the possible infringers may be accomplished by virtue of *different legal remedies and technologies*.

Protection of the property right against unauthorized use by individuals may be ensured by a range of *technical means* (locks, fencing, alarm systems); use of *own physical strength* or *guards hiring*; soliciting services of *private security agencies*; or *law enforcement bodies*. In the majority of instances the use of technical means proves a viable solution to prevent infringement upon the property rights by certain individuals.

Protection of the property right against unauthorized use by legal entities, capable of seeking to offend the right in question by enlisting both private or state power agencies, with only technical means may prove ineffective, in which case hiring of *safeguarding services* from *private security* or *state law enforcement* bodies may be a solution.

Protection of the property right against its use by the State not authorized by its holder is *the most trying*.

First of all, the State as a lawmaking entity may always introduce a *legislation* validating taking of rights to assets from private owners (e.g. taking of land plots required for the construction of highways, streets, etc., whether with or *without compensation*, i.e. expropriation, etc.)

Secondly, certain government organizations (agencies) may introduce regulations that put restraints onto earlier specified property rights and by so doing confine discretion of the property right holder to exercise the right to which he/she has been entitled, i.e. purportedly infringe thereupon.

Thirdly, certain public officers may by pulling rank (if not abuse of office) and threatening sanctions from a supervisory or a law enforcement body *actually* enjoy a property right which officially could still remain vested with its already nominal holder (graphic example: business capture by an influential bureaucrat).

Obviously, a remedy against property right offences committed by the *legislative branch* of the state power (subject to a constitution that effectively bans property takings without adequate compensation, etc.) may be a Constitutional Court or first and foremost a political opposition constituting a real competition to incumbents (i.e., similar to a market entry threat).

Remedies against property right offences committed by *executive authorities* may include:

- ⇒ Special procedures of introducing regulations enacted by the law providing liability for breach thereof³;
- ⇒ Independent and politically unbiased judicial system.

Remedies against property right offences committed by *bureaucrats* may include:

- ⇒ Set of measures ensuring transparency for the public of not only officers' sources of income/expense but of their next-of-kin as well;
- ⇒ Code of public officers' conduct in place;
- ⇒ Independent and politically unbiased judicial system.

A special case of property rights protection relates to *protecting rights* to assets *inside* separate (irrespective whether private or public) *organizations*. We are talking about the use of assets by hired workers *for purposes other* than those designated for them by the owner.

Protection in this case is ensured through a wide range of remedies. Sometimes it would be sufficient enough to organize a physical protection of assets against unauthorized use. A viable solution is a so-called incentive contract that encourages employees to meet the principal objectives. An equally effective remedy is to develop and introduce a special corporate legislation (conditional to independent and politically unbiased judicial system to prevent the application of the corporate legislation by influential bureaucrats in pursuance of own ends, say, for a business capture).

To protect property rights during *legal transfer* to other holder means to create conditions whereby a respective contract in the event of its unilateral termination will not lead to loss of transferable right without compensation stipulated therein. In other words, protection of property rights during transfer is nothing else but *protection of contractual rights*.

In terms of property rights protection, it is important to distinguish between (1) contracts *between private agents* and (2) contracts *between private agents and the State* (whether represented by any organization vested with authority powers or the State itself).

Protection of rights under the contracts *between individuals* may be exercised in different forms, including by *suing to law court for redress*. Frequency of law suits is normally 30%⁴ on average as private economic agents wield a significant variety of instruments that heighten reliability of "horizontal" contractual relationships. In fact, law suits are the "last resort" i.e. applied only and when all other measures to enforce fulfillment of the contract have been exhausted. It should be noted that *sine qua non* for the effective protection of contractual obligations at court is strict enforcement of court rulings and independence of the judicial system *from any political manipulations*⁵.

³ Procedures need to provide for public scrutiny of a draft regulation with obligatory participation of all stakeholders, a possibility to legally contend the regulation whether adopted in violation of the procedure or affecting economic conditions of the regulation objects.

⁴ This number does not vary greatly in both developed economies and emerging markets.

⁵ Strange as it may seem, independence of the judicial system *from being bribed* by a party in a purely private legal conflict is not much critical in terms of value creation within the framework of the entire economic system so long as "responsiveness" of court to corruption in this case means that the asset in question is transferred to whomever values it higher. Accordingly, it adds to the value created although for a losing party in the dispute this bodes evident worsening of its economic situation. As for court's "responsiveness" to the pressure from authorities, this would have much more *detrimental* effect in terms of impact on incentives for productive use of resources as in the end the asset in question is transferred not to a more effective owner but to the one stronger (i.e. capable of mustering administrative clout in pursuit of own ends).

Protection of rights under contracts *between a private person* (private organization) *and the State*, on the contrary, can rely *almost entirely* on judicial protection which to be effective, needs to qualify under the following criteria:

- ⇒ legislation not only assuming but *laying emphasis on enforcement*⁶ of the State's liability owed to citizens or organizations;
- ⇒ Independent *and politically unbiased* judicial system.

Such differences in the protection of contractual rights between purely private contracts (i.e. entered into between private persons and/or private organizations) and private-government contracts (entered into between the government and private person or private organization) are naturally accountable for the fact that *forcing potential at the State's discretion is always higher* than the potential that could be mustered by any no matter how influential private organization.

To reinstate or restitute infringed property rights means to "physically" return to the former owner the asset in question or the possibility of using it (together with compensation for the lost profit for the period during which the right has been violated). Reinstatement of rights may be performed either by their initial guarantor or by virtue of a court ruling fulfillment. Therefore, availability and effectiveness of the court rulings enforcement system is the integral (although not the only) indicator of viable *judicial system*.

To summarize the above assertions vis-à-vis *the role of the State* in improvement of the situation in the area of property rights, a table is presented below where rows contain constituent elements (steps) and columns contain branches of authority.

Table: Participation of the branches of power in improvement of the property relationships

| Steps of improvement | Branches of authority | | |
|-------------------------------------|-----------------------|-----------|----------|
| | Legislative | Executive | Judicial |
| Specification | + | + | + |
| Protection at proprietor's location | + | | + |
| Protection during transfer | + | | + |
| Reinstatement | + | + | + |

Bodies of the **legislative authority** adopt rules (laws) to regulate the processes of specification and protection of property rights, **executive authorities** (along with the court) implement specification of rights by rendering public administrative services whilst **judicial authority** bodies resolve conflicts in the area of property rights and redress the wrong (in conjunction with the executive bodies).

⁶ For instance, under the existing Russian legislation *technically*, liability of the State for breach of contract *does exist*, however, *in reality* an affected party can receive a compensation only if the respective funds are *provided in the budget*. In a situation when a party in breach of contract is the executive branch whereas the budget is adopted by the legislative authority nothing can prevent the latter "with a purpose of improving efficiency of budget spending" to not allocate regularly the claimed amounts into the budget of government organization/agency that has failed to pay up the contract (e.g. an amount of publications in press about situation for the payment of government orders).

It should be noted that **omissions** in Rows "Protection (of property rights) at proprietor's location" and "Protection during transfer" for Column "Executive branch" **do not mean** that executive bodies **do not at all have anything to do** with the steps of the property relationships improvement. What they actually mean is that performance of the respective functions **is not only the responsibility of the State** so long as there exist (and are in fact actively employed) significant possibilities **on the part of right-holders themselves** and that of private organizations selling respective protection services.

At the same time, in situations when **executive authorities** themselves (e.g. as represented by local policemen) act as an **active infringer** on the property rights (as evidenced by numerous facts of extortion from small-size and medium-size businessmen in connection with allegedly detected – actual or colorable – violation of various regulations), only higher hierarchy levels of the executive power or independent court are able to ensure protection of the property rights.

Consequently, it is in the area of **rights protection** that availability of **independent** from any political influences (i.e. influence that might be exerted first and foremost by the executive authorities) **judicial system**⁷ is the most critical.

While stating primary involvement in the improvement of property relationships of the **legislative** and **judicial** branches of authority it would be important to emphasize importance of *executive authority* in the context of creation of an **adequate material and technical infrastructure** supporting other constituent parts of the State guarantee of specification and protection of property rights. This significance particularly matters given the current Russian environment when *political competition* from both the outside and inside between legislative and executive branches are virtually nonexistent.

1.2. Indicators of property and contractual rights protection degrees

As is seen from the assertions provided herein⁸ the most critical components of the property rights specification and protection include the following:

- (a) degree of protection of the property rights against offences *committed by the State* and
- (b) degree of protection of the contractual rights.

With respect to both, endeavors of international institutions have resulted in development and existence of special *indicators* of the abovementioned degrees of protection for various jurisdictions.

The above indicators are defined by experts; their analytical content *is not disclosed* (only name of the specific indicator's developer is known).

Current and projected values of exposures to property expropriation by the State country-wise (degree of protection of property against expropriation by the State) as part of the Political Risk System (or International Country Risk Guide) may be *acquired* from PRS Group, Inc., reachable at: [http:// www.prsgroup.com](http://www.prsgroup.com).

Dynamics of these indicators may be used to evaluate efficiency of efforts undertaken by the State for improvement of the property rights protection.

Alternative measure (indicator) of the property protection against expropriation by the State is developed within the framework of Polity IV Project implemented by the

⁷ For strict definition – see Section 2.4.

⁸ See also information included in Section 2 hereunder.

University of the State of Maryland that provides data on all independent countries with population over 500 thousand over the period from 1800 to 2003 (as of 2004; data on 2004 will be provided in 2005 and so on). Within the above project database, a measure of effectiveness of *constraints imposed on activities of government authorities* is provided. This information is *freely accessible* at: <http://www.cidcm.umd.edu/inscr/polity/>

Both indicators may be used in the budget planning system for description of *results attained* in enhancement of property rights protection. At the same time, they will unlikely be used for *target indicators* as their *values are dependent on a multitude of factors*, including those outside of BPS' scope of reference.

Direct indicators of rights protection reliability in a particular country are included in the Index of Economic Freedom regularly published by the Wall Street Journal/Heritage Foundation⁹ or in the Economic Freedom of the World Annual Report prepared by the Fraeser Institute¹⁰. These indicators characterize degree of property rights protection by virtue of laws in place and protection of private property against expropriation.

To evaluate protection of contractual rights, the use was made for *research purposes* of such an indicator as *number of formal legal procedures* required to resolve common conflicts. These were assumed to be: (a) money receipt for the contract performed and (b) deprivation of a lessee of the rights for nonpayment of the lease fee¹¹. The above indicators were simultaneously measured at each of the surveyed countries.

As is shown by results of the survey, in countries with a high *level of legal formalism* (which for that matter is measured by the above indicator) costs incurred in the protection of common contracts are higher, legal procrastinations are longer while objectivity and efficiency of legal system is lower. It enables us to arrive at the conclusion that the *higher is the level of legal formalism, the lower is the degree of contractual rights protection*.

Unfortunately, the above indicators of contractual rights protection are only productive for comparison across countries or when it comes to assigning a final score to a particular country. They cannot be measured internally as target numbers within the framework of a budget planning system for the simple reason of being highly exposed to willful distortion without any positive effect whatsoever for the contractual rights protection.

A common measure of the property rights protection which may directly be determined by local statistical bodies is the *number of small businesses* operating in Russia. This is owing to the fact that small businesses, having no a clout to resist the pressure from the State, promptly respond to any changes in the degree of rights protection. If their *numbers decrease* it will be a sure sign that the *situation is worsening* whereas *swelling ranks of small businesses* are indicative of *positive developments* in the country. This measure is also good in that the misstatements, if any, can hardly be upward (except for direct write-ups which, again, no measure can be completely ridden of).

⁹ Miles M., Feulner E., O'Grady M.A. 2004 Index of Economic Freedom: Establishing the Link Between Economic Freedom and Property. The Heritage Foundation and Dow Jones Company, Inc. 2004

¹⁰ Gwartney J. and Lawson R. Economic Freedom of the World Annual Report 2003. Fraeser Institute, July 2003. accessible at: <http://www.fraeserinstitution.ca/shared/readmore.asp?sNav=pb&id=551>.

¹¹ Design of and indicators measurement guidelines are described in the following publications: Djankov S., La Porta R., Lopez-de-Silanes F., Shleifer A. The Regulation of Entry // Quarterly Journal of Economics, 2002, 117 (1), pp.1-37; Djankov S., La Porta R., Lopez-de-Silanes F., Shleifer A. Courts // Quarterly Journal of Economics, 2003, 118 (2), pp.453-517.

As a complement to the above indicator it would also be reasonable to regularly evaluate the following:

Business startup period (days);

Amount of loans provided to SMEs (except for trading businesses).

The first measure is indicative of openness of markets to entrepreneurs, the second - accessibility of financial resources. To the extent that provision of loans is at the bank's discretion this measure may also reflect a degree of the bank's confidence in debt recovery i.e. reliability of property rights protection in this area.

The informative indicator of the property rights protection may also be the *number of noncompliances* with the Federal Law (FZ) No. 134 "Concerning Protection of Rights of Legal Entities and Entrepreneurs During Execution of Government Control (Supervision)" across relevant federal services along with Interior Ministry and other power ministries and agencies. To prevent distortions of this indicator it would be reasonable to provide for creation of an independent government organization (agency) that will report directly to the government leadership and will be responsible for recording such noncompliances.

As an option, *independent analytical agencies* may poll entrepreneurs on a *test basis*. Surveys performed by CEFIR¹² serve as a graphic example. These contain data characterizing the level of pressure on entrepreneurs exerted by regulatory bodies.

1.3. Recommendations on reflecting targets of property rights protection improvement in the activities and budget reports of executive bodies

As it follows from the table presented above and the preceding assertions regarding the property rights protection structure, on the face of it the *role* of executive bodies in tackling the above problem seems *insignificant*. Indeed, judging by the table, roles of **legislative** and **judicial** branches are far more critical for protection of property and contractual rights.

However, this conclusion *is not entirely correct* as it does not reflect the role of ministries and agencies vested with the authority of draft laws preparation and implementation of bylaws, the role of federal services as that of regulatory bodies, as well as the role of the executive bodies in general in providing for material and technical infrastructure supporting functions of legislative and judicial branches through preparation of the respective budgeting decisions.

Example: the *level of judges' compensation* that significantly impacts their exposure to economic pressure "from below" i.e. their "responsiveness" to bribes offered by parties to the civil proceedings or to requests from the local authorities is *not* determined *inside* the judicial system. Likewise, the size of legal charges in arbitration processes which could sizably impact the number of petitions filed is not left at the courts' discretion, etc.

Accordingly, at least in the area of *contractual rights protection* SBP's capabilities seem significant.

Executive bodies (SBP) play an exceptional role at the stage of *property rights specification* without which rights' protection lacks any rationale. With this regard, we must draw attention to both unreliability of rights protection specification in a number of

¹² Reports on rounds of study within the framework of the "Monitoring of Administrative Barriers to Development of Small Business" performed by the Center for Economic and Financial Research and Development (CEFIR) under the assistance of the World Bank and sponsorship of US AID: <http://www.cefir.ru/>

industries (e.g. still unresolved problem of the central government depository of securities which, if created, will improve protection of title thereto) and numerous administrative hurdles in the provision of public authority services which increase the cost of specification (for owners) and has a destimulating effect on seeking legal specification (while, on the contrary, encouraging bribing of or informal arrangements with public officers, etc. which mar business environment in the country). Passing of the new law concerning registration of legal entities as is evidenced by the way it is implemented has not radically turned the situation for the better whereas the lack of regulatory basis for other administrative services does not allow speaking about any progress in the area of property rights specification either.

Accordingly, visible **acceleration of lawmaking process in the area of administrative services** is the SBP's top priority in validation of proprietary relationships. Draft laws in the area of administrative standards and technical regulations despite a number of disputable and incorrect assertions in the publicly available versions are undoubtedly steps in the right direction.

Besides, a common form of the executive bodies' participation in meeting the above objective may be **preparation of draft laws to improve property rights protection within SBP scope of authority**.

The question as to *specifically what draft laws* would be reasonable to develop can and *should* be decided through SBP's broad *dialogue* with the market agents operating within their scope of responsibility (associations of businessmen, representatives of local communities, etc.). This is the only way to highlight really urgent problems whose solution may have a truly positive effect on the level of business activity and wellbeing of the population.

Example: under the current legislation that allows for a "rolling" disconnection of default regions from sources of electricity, heat and water supply contractual rights of the utilities end-users that *accurately pay* for the services provided are infringed. However, imposition of efficacious sanctions against the services providers is very much doubtful, if possible at all. Therefore, modifying legislation so that it enjoins "rolling disconnectors" to indemnify diligent payers for both physical losses and moral damages may strongly encourage them to implement innovations.

An important step in the improvement of property rights protection would be **introduction in the legislation of officials' liability for infringement upon somebody's property rights** through recovery of the damages sustained out of *the current budget of the agency with subsequent levy of execution to the property of the officer responsible*. It would only be natural that facts of damages infliction and the need for indemnification are established through *court proceedings* wherefore a true independence of court from authorities must be guaranteed.

Example: regulatory and supervisory bodies not infrequently resort to seizure of documents and suspension of commercial organizations' activities during field audits/reviews, etc. In instances where the above audits revealed no noncompliances on the part of the audited organizations the damage actually inflicted to the latter during the audit is not made up for which fact essentially constitutes infringement of one of the property rights i.e. the right to derive profit from the property owned.

Introduction in the legislation of officials' liability for infringement upon somebody's property rights may most easily be made effective through *amending and appending* of the Federal Law No. 134-FZ "CONCERNING PROTECTION OF RIGHTS

OF LEGAL ENTITIES AND ENTREPRENEURS DURING EXECUTION OF GOVERNMENT CONTROL (SUPERVISION)" so that its scope be directly related to activities of **law enforcement bodies** (police) and **other power agencies** which currently are not subject thereto.

Insomuch as a significant part of the assets is still in the state ownership — be it in the form of government or unitary government enterprises (GUE) — or in the ownership of municipalities it would be important from the perspective of proprietary relationships validation is to **ensure protection of the State's (and municipalities')** property against their unauthorized use by hired managers, leadership of the government and municipal enterprises.

According to international best practices, a relatively reliable form of above protection would be entering with top managers of the government enterprises into *incentive contracts* whereby their compensation is directly linked to efficiency of the government assets' management and may be *reduced* if the efficiency *decreases*. Direct losses of the government property must be recovered by the property of the manager if found guilty in court. Needless to say, emphasis should be laid not only on conclusion but *performance* of the above contracts which presupposes both development of auditing mechanisms within SBP that oversees the enterprises in question and availability of independent judicial system capable of handing down rulings unswayed by any pressure that top managers of government or municipal enterprises could muster through connections in federal, regional or local administrations.

Accordingly, another area of SBP activities that needs to be reflected in the budget reports is *drafting and signing of the contracts with management of subordinate enterprises* with follow-up on compliance.

In this regard, a target measure for the coming years may be the *share of subordinate enterprises whose CEOs have signed the above contracts*.

The proposed directions and forms of BPS involvement in the process to improve, streamline and protect property rights appear to provide enormous opportunities for inclusion of appropriate actions and procedures into BPS budgetary reports, and also define possible *interdepartmental programs* designed to achieve the stated objective. Appropriate events scheduled for implementation by separate departments, naturally, should be organized in the form of *intradepartmental programs*

At the same time, BPS *capabilities* to achieve objectives of significant improvement of the situation in the area of property rights and contractual rights protection within the framework of their daily activities seem to be *rather limited* in comparison with the scale of the objectives. As the **principal burden of protection of the said rights is placed on the judicial system**, which in practice continues being *dependent* to a greater degree of the political influence exercised by executive power bodies.

Thus, capabilities of the judicial system to protect business from being seized by the state, or rather by influential governmental officials using the state potential to achieve personal objectives are drastically narrowed. That is why the judicial reform aimed at enhancement of independence of the legal system from the state's executive branch of authority continues to be the most significant area for improvement of the property right protection situation. Successful movement along this road is objectively *restrained by* peculiar features of the existing political system within the framework of which the degree

of success is mostly determined by competition between political parties defending different country's development strategies¹³.

In general, within the budget planning framework BPSs, judging from the above, *avail themselves* of certain opportunities to reflect objectives of streamlining and better protection of property rights in their current and prospective operations as well as in their budget Reports. The principal opportunities are described in this Report's section.

1.4. Strategic options to resolve the property right protection problem

Selection of the strategy aimed at improvement of protection of property rights is conditioned to the greater extent, in our opinion, by the *scenarios of development of the Russian economy* to be implemented in the foreseeable future.

*Two scenarios, which seem to be realistic and can be chosen as basic scenarios may be conditionally described as **natural-resource-based** and **innovation-based** scenarios.*

Within the framework of the natural-resource-based scenario, which follows the established functioning and growth tendencies of the Russian economy, the predominant part of governmental revenues will have a non-tax character, i.e. being formed by excise duties levied on exports of raw materials industry.

Accordingly, the state's rational behavior pattern will go along the line of increased protection of *public property* rights to natural resources while at the same time will continue to perceptibly avoid being actively involved in the process of protection of private property rights in other sectors of the economy. To be more precise, such participation will be ensured to the extent sufficient to maintain the *acceptable* level of protection of property as well as other rights of citizens which does not generate mass protest actions.

Within the framework of the innovation-based scenario, which provides for significant expansion of private entrepreneurial activity of citizens in the sphere of research and development, the activity to streamline property relations described above will not be able to ensure transition of the national economy to the desired state¹⁴. After all, the already mentioned *mass innovation (and investment) entrepreneurial activity*, without which the transition of the national economy to post-industrial technological forms is unthinkable, requires *reliable property rights protection accorded by the very state*. The thing is that due to high risks of innovation activity, transfer or preservation of rights protection overheads over to entrepreneurs themselves will exert a de-stimulation influence on their decisions to take part in the innovation business operations.

Accordingly, only in case of implementation of this scenario **all** directions of activities we discussed hereinabove will become rational, and first of all achievement of real independence of judicial system and drastic improvement of judges' qualification levels.

At the same time, while planning measures to improve protection of property rights which constitute one of the structural components of the process of implementation of the innovation development scenario, one should take into account the *risk of opposition to measures to streamline private property rights from the part of public servants who in more or less degree practice attenuation of these rights*¹⁵.

¹³ In more detail, these issues are highlighted in section 2.4 of the present report.

¹⁴ We would like to mention that in the wake of this period state revenues will be predominantly generated by taxation of profits of private enterprises (and private revenues), i.e. represent part of newly created value.

¹⁵ The nature of this risk is analyzed below in section 2.2.

Existence of such risks, strictly speaking, is a characteristic feature of the "extrapolative" resource development scenario, as the increased protection of public property rights from their unauthorized use by public enterprises' managers will inevitably affect interests of those public servants who directly or indirectly receive certain benefits from that. However, the counteraction *scale* in this scenario will be significantly smaller than within the framework of the second, innovation scenario.

Organizational forms of coordination of state authorities' actions to implement the appropriate option of the policy to streamline property relations within the framework of each scenario may be different.

Within the framework of the *first* scenario it is quite sufficient to include the above-mentioned (and possible other) measures into BPS budget reports; meanwhile coordination will be organized in the form of programs to achieve inter-departmental objectives as basic actions will be undertaken by executive power bodies (including preparation of draft laws for the legislative branch).

Within the framework of the *second* scenario such form of coordination will be evidently not enough as it will be necessary to agree sequence and priorities of actions with the *judicial authority branch* (as well as with the legislative authority branch). In addition to that, it is extremely important in the context of this scenario to have wider involvement in the process of *civil society organizations as well as business community organizations*, which, in general, function outside the state's power structures. That is why in case the political choice is made in favor of the second scenario, special developments will be required in the area of effective coordination of actions between the power authorities, civil society and business.

2. Methodological justification of recommendations to validate property relations

This section of the report contains theoretical basis of particular recommendations formulated in the first part of the report. It does not present an integral, consecutive text as it is aimed at demonstrating the results achieved by the modern economics (The New Institutional Economics) and serves as a basis to develop recommendations on measures of economic policy in a number of economically developed countries.

2.1. Property rights: principal concepts

The contemporary economic literature practically makes no use of the "*property relations*" term (with the exception of the Marxist direction of economic thought). Instead the term "**property rights**" is generally applicable.

The term **property rights** means those **actions** or **set of actions** with objects (resources, means of consumption) which an individual or any other subject of actions may perform with the object without risking any sanctions used against him by other subjects. In short, property rights represent actions with assets permitted by the society.

The theory of property rights proceeds from the assumption that any act of exchange of goods is really an exchange of bundle of rights. Such interpretation assumes that the wider the bundle of rights assigned to the resource, the higher is its value. According to Alchian-Demsetz conception, right of ownership consists of the following basic property rights: 1) the right to use a resource; 2) the right to transform the resources; 3) the right of the economic profits of resources and 4) the right selling all the other rights to other people¹⁶.

The more detailed characteristic of the right of ownership which by now became generally accepted was put forward by British lawyer A.Honore. His system of property rights comprises 11 elements (entitlements): 1) the right to possess, i.e. to exercise the exclusive physical control over a property item; 2) the right to use, i.e. to personally use the item; 3) the right to manage, i.e. to decide how and by whom the item may be used; 4) the right to income, i.e. to advantages resulting from the previous personal use of the item or from permission given to other persons to use the item (in other words, the appropriative right); 5) the right to capital: the power to alienate, consume, waste, modify or destroy the item; 6) the right to security, i.e. to immunity from expropriation; 7) the power of transmissibility; 8) the absence of term; 9) prohibition of harmful use, i.e. the obligation to avoid using the item by means which are hazardous for others; 10) liability to execution, i.e. the possibility of the item being taken away in satisfaction of a debt; 11) the residual character, i.e. expectation of "natural" return of right assigned to somebody upon

¹⁶ Alchian A. Some Economics of Property Rights // *Il Politico*, 1965, 30: pp.816-829; Demsetz H. Toward a Theory of Property Rights // *American Economic Review*, v. 57, n.2, May 1967, pp. 253-257; Alchian A. and Demsetz H. The Property Rights Paradigm // *Journal of Economic History*, 1973, v.13, n.1, pp.174-83.

expiration of the assignment term or in case of loss of validity of the assignment due to any reason¹⁷.

In respect of determination of the bundle the property rights of which form the structure of the right of ownership it is important to stress the following:

1) Part of rights may exist only in a cluster (or bundle), i.e. they are complementary and do not possess any value if taken in isolation. For example, the right to revenue is senseless if there is no right of security as the low probability of earning revenue due to absence of security means that the legal faculty is fictitious. The right to use is often combined with the right to income especially when it is impossible to differentiate between the evident and implicit revenue. This right turns out to be an integral part of the right to capital as the value of the latter is determined through a discounted flow of expected benefits. Moreover, not all of the indicated rights are characterized by equal significance from the point of view of impact on the value of assets. The principal elements of the complex of property rights usually encompass:

- a) the right to exclude other agents from the access to resource (protection right);
- b) the right to use the resource;
- c) the right to receive revenue from it;
- d) the right to transfer all previous rights.

2) It is necessary to differentiate between the exclusive property rights and their transferability. In particular, a person may possess the exclusive right to exercise physical control over and use of a land plot but may have no right to sell or mortgage it. Here it is assumed that the violation of this right for a farmer is connected with prohibitively high overheads, so the property rights de-jure coincide with property rights de-facto.

3) There exists a principle distinction between the exclusive and absolute property rights. The exclusivity of the right for an individual person may exist if the 9th right is applicable because it does not allow to speak about the right of ownership as an absolute right. Limitation of the right of ownership under this right is a significant element of the system of structured relations between people. However, it does not mean that it will certainly ensure better efficiency to correspond, for example, to conditions of equilibrium in the ideal competition environment.

In connection with the correlation between the exclusivity and absoluteness of the right of ownership it is necessary to state that in an economic system where the human behavior affects wellbeing of other people and behavior of people indirectly results in changes in the state of the wellbeing of this particular person, external effects emerge constantly. It is impossible to totally internationalize all effects, and because of that, characteristics of economic systems will be dependent on the priority of internationalization of specific factors. This to greater degree is determined by the applicable rules of the highest order (sometimes described as an institutional environment) which condition the comparative efficiency of areas of internationalization which in turn correspond to characteristics of exclusive property rights.

4) Economic literature lacks a uniform, generally accepted classification of property rights. As a first step towards elimination of a conflict between different standpoints in relation to classification of the rights, it should be worth revealing the factors affecting some combinations of the rights.

¹⁷ Honore A. M. Ownership. - In: Oxford essays in jurisprudence. Ed. by Guest A. W., Oxford, 1961, pp.112-128

The more differentiated are relations between people on the subject of things, the more useful becomes the detailed classifications of rights from the point of view of adequate reflection of the character of the relations. Taking into account that differentiation of relations is a process, which accompanies allocation of resources, its integral characteristic features the process of splitting of the property right, which permits revealing a majority of legal rights. Consequently, the nature of this process in each specific case determines characteristics of legal rights. It is worth noting that the process of the right of ownership splitting is one of the dynamic characteristics of relations between people in respect of limited benefits alongside the processes of specification and attenuation of rights.

5) Like economic rights being formal and informal, so property rights may be the de-jure and de-facto rights. Such an approach to the problem requires overcoming of overly regulated legal theory oriented towards formalized rules. It also helps explaining functioning of the land market as an instrument to transfer property rights in the situations when the latter are not specified and not protected by the state.

Property rights represent a particular case of rights in general. The *right* of an individual is commonly defined as such *actions or set of actions*, which he can perform *without being threatened by possible sanctions applied against him by other individuals or organizations*.

It is important to note that the rights possessed by an individual are determined by the aggregate of *rules* applicable in the society. The rules in this case shall be understood as formal provisions such as the constitution of the country, laws, decrees, edicts, governmental instructions, etc., as well as informal rules, such as traditions, habits, internal group regulations, etc. Change of rules leads usually to changes in rights, including property rights.

Each formal or informal rule characterizes:

- An addressee of the rule (who exactly should follow this rule);
- Terms and conditions of its application (in which case the addressee should follow the rule);
- Contents of the rule (what exactly the addressee should or should not do under certain conditions);
- Guarantor of the rule (who establishes whether the addressee complies with the rule and in case of the violation applies sanctions against the addressee);
- Sanctions for violation of the rule.

It is clear that the *contents of the rule* actually determines *rights of the addressee* – permitted or assigned actions while performing which the individual does not risk facing sanctions applied the Guarantor. That is why the variety of rules applicable to the economy matches the variety of rights, which addressees of these rules possess.

Some of the rules applicable to the economy determine the long-term or even perpetual assignment of rights to an individual; other rules define rights existing in the course of strictly defined time periods. For example, within the framework of a lease agreement the lessee obtains the right to use the leased assets only in a strictly defined manner and in the course of a pre-determined time period, while the receipt of the title to real estate means that the term and means of its use are practically limitless, etc.

Property rights may be of formal and informal character. Formal property rights are defined within the framework of the legal system of the state; informal rights are based on traditions, habits, informal agreements between individuals and organizations.

The most important characteristic of any rights, including the property right, is the level or degree of their *exclusivity*. Exclusivity of a right usually means the possibility to *exclude other subjects* from the process of making decisions related to actions with an property object. For example, within the framework of joint ownership of some asset by two individuals *each* of the owners separately *does not possess the exclusive right*, though *jointly* their right is the *exclusive one* as no third party can *legally* interfere into their actions related to use of the property (provided however, there is no rule to the contrary). Meanwhile illegal interference may be quite possible.

That is why it is necessary to differentiate between exclusivity and *protection* of a property right. Protection of the property right means *existence of obstacles* preventing illegal owners from performing actions with the property object, which constitute the contents of the right exercised by other subjects. For example a citizens' right to own a land plot may be of the exclusive character, i.e. formally belonging only to the citizen; nevertheless it may turn out to be unprotected if other citizens will unobstructedly, without being subjected to punishment or a threat of punishment, gather fruits harvested on that land plot.

2.2. Specification and attenuation of property rights

The composition and sources of various obstacles to prevent unauthorized access to this or that property right are defined in the course of the procedure described as "*specification of property rights*".

To specify any property right means to determine who, with what object, what exactly, under which terms and limitations, may unimpededly perform, and what guarantor or guarantors will prevent interference of other subjects into the rights exercised by this subject.

Specification of some property right may be of a formal as well as informal character. Formal specification is carried out by the state, its bodies of *executive* or *judicial* authority. In this case, the state will play the role of a specified right guarantor represented by law enforcement agencies. Informal specification is performed and carried out usually by members of a group: a family, neighborhood community, etc.

At first glance it may seem that *formal specification is always more reliable than the informal one*, i.e. the level of the right protection accorded by the state is always higher than the level of protection provided by informal means. In reality, it is not always the case as specific actions constituting the process of specification, are actually performed not by an abstract "state in general", but by quite real *public officials* for whom such actions are just *the means* to make money, to generate revenue. So they are interested in providing high quality services to the extent they affect the level of their remuneration. If the connection between the level of their efforts to ensure quality specification of property rights and their salary level is *weak* or *non-existent*, one might expect that a public official will perform the required actions on a minimal permissible quality level, which may turn out to be even lower than in the process of informal specification of rights¹⁸.

¹⁸ Note that such quality correlation takes place also in the process of comparing formal and informal *protection* of property rights.

Nevertheless, the informal specification and property right protection processes have their natural restrictions related to *limited potential of violence* possessed by the guarantor in comparison with potential violence capabilities available to potential perpetrators of a specified right.

The process, which is the opposite to the process of specification of property rights, is their **attenuation**. Property right attenuation means an intentional introduction of **uncertainty** in some components of the specified property right. The subject of the process of attenuation of the property right is the same subject, which performs the right specification function, i.e., the **guarantor**. In this respect *attenuation* of the property right differs from its *violation* as usually the *perpetrator of the right* is represented by a *third party* that differs from the subject of the right and from its guarantor.

Taking into account that in contemporary societies, the state plays the role of the mass guarantor of property rights, then attenuation of the property right is also related to actions of the state. Consequences of such attenuation of property rights both on a theoretical level and against the background of multiple historical examples were investigated by D. North¹⁹. For the state aiming to replenish its budgetary resources diluted and thus unprotected from gratuitous taking property rights of its subjects often bring benefits as they facilitate resolution of the problem to support the required level of governmental expenses. Nevertheless attenuated property rights, while being beneficial in a short-term perspective, create difficulties with replenishment of the budget in the long-term run, as the weakening of property rights exclusivity decreases the degree of future certainty for economic agents, increases risks thus cutting down the incentives towards investment activity²⁰.

As the state is not a solid entity but rather a sum of different governmental and executive bodies employing government officials who are both able and ready to improve their wellbeing by abuse of official position, property rights can be attenuated not even in the short-term interests of *the State* but in the interests of certain government officials or lobbyist groups.

In this connection, any actions of the State, departments or individual officials intended to *restrict (attenuate) property rights* should be *a priori* suspected that proposed attenuation of property rights would be in the interests of *lobbyist groups* led by *redistribution* considerations rather than *creation and growth of public wellbeing*.

One would think that as poorly protected property rights have an adverse effect on economic growth and, in the final count, lower the incomes of the State and the power elite, it would be logical to expect special efforts on their part aimed at development of institutions of specification and protection of property rights, particularly, of *private ownership* as this types of ownership ensures the most powerful incentives for efficient use of resources and, therefore, for economic growth. Meanwhile, the practices of almost all developing and transition economies *do not support* such conclusion.

Such discrepancy can be explained by incorrectness of the *above logical conclusion* which ignores the expenses which should be incurred by the State (incumbent elite) to improve protection of property rights. Neither does it provide for comparison of such

¹⁹ D. North, Institutes, institutional changes and economic performance. M.: "Nachala", 1997 (in Russian)

²⁰ In more detail, the above range of issues is described in a number of publications, for example: Institutional Economy: New Institutional Economics. Manual. Ed. by A.A.Ausan. M.: "Infra-M", 2004 (in Russian)

expenses with the cost of alternative technologies of increasing government revenue based on attenuation and appropriation of property rights of citizens.

These issues are currently studied within the framework of economics of the state where two main trends have taken shape and are developing.

The first trend views the State as an agent of its citizens who authorize the State to integrate their preferences and make a collective choice as to distribution of resources and revenues. Such approach treats the right to collect taxes as the principal way of realizing collective choice as taxation becomes the means of preventing citizens from evading participation in financing the production of public goods.

The second trend treats the State as an instrument of realizing the interests of the ruling elite. Such approach interprets the government activities as efforts intended to maximize the profits of the ruling elite. From this angle, the State is not different from a private firm which also operates in the interests of its owners to maximize their wellbeing. Consequently, the main types of government policies (legal, budgetary, tax, investment, etc.) are similar to corporate strategies aimed at profit maximization.

Evidently, the above logical conclusion on inevitability of government efforts to improve protection of property rights relates to the theories of the first group (the State as an agent of citizens). The lack of evidence supporting this conclusion makes us look for explaining and forecasting models in the second group of theories (the State as a predator or proprietor). The above concept of property rights attenuation also correlates with this trend in the economics of the State, and the studies mentioned below describe this concept in detail identifying conditions contributing to the government policy of property right attenuation rather than to the policy of specification and protection of property rights in respect of the assets which do not belong to the ruling elite.

As the studies dedicated to these issues are numerous we will describe only a few papers mostly published in recent years, and we will rank them along the *logical* rather than *historical* line. Their common feature is the focus on identification of conditions in which the “predatory” behavior of the State becomes stable, i.e. conditions suppressing the citizens’ incentives to change the established regime.

The model proposed by K. Sonin²¹, analyzes the dynamics of the government protection of property rights. When such protection institutions are inadequate economic agents develop incentives for their private protection. Thanks to the emergence of economy of scale, rich agents get significant advantages: they can expropriate the property of the poor using the potential of violence created by them. By so doing, the rich become opponents of completely adequate government protection of property rights. In other words, such conditions do not give rise to an adequate “demand” for institutions supporting economic growth, and national economy finds itself in a poor equilibrium characterized by low growth rates, high level of inequality in the area of property and living standards, and prevalence of behavior aimed at revenue appropriation rather than value creation.

Research conducted by D. Acemoglu, J. Robinson, and T. Verdier²² analyzes the *kleptocracy* phenomenon common for many developing economies. This term means the personal rule regime conducting an utterly ineffective economic policy (from the point of view of value creation maximization). Within such policy, the ruler expropriates the

²¹ Sonin K. Why the Rich May Favor Poor Protection of Property Rights. William Davidson Working Paper n. 544, December 2002

²² Acemoglu D., Robinson J.A., Verdier T. Kleptocracy and Divide-and-Rule: A Model of Personal Rule. NBER Working Paper 10136. December 2003

property of its subjects for ambitious projects or personal consumption. The work shows that kleptocracy success and duration is based on the ability to use the “divide and rule” strategy – small thanks to the weak institutions in such countries. Weakness means the lack of efficient law enforcement mechanisms which would work no matter who the guilty person is. Any collective effort to remove the kleptokrat is very difficult to undertake as the ruler can expropriate the property of suspected plotters and redistribute it to those who do not oppose such rule.

The model described in the article proves that kleptocratic policy is more likely to emerge when foreign aid and/or revenue from natural resources are sufficient for the ruler to buy off opponents; when rival groups are guided by short-term interests, average productivity is low, and inequality between groups of economic agents is significant (as the best performing groups are more difficult to buy off the ruler has to expropriate mostly the property of other groups).

A “softer” situation is considered by J. Mendoza²³. The State is not an active expropriator, it has to choose between alternatives whether to accept the level of property right protection established by the efforts of private agents or contribute to ensuring such protection. “Setting aside the cost of the government protection of property rights the government’s gross income will be higher if the State participates in such protection, because of strategic advantages of reliable protection of property rights. But decision to participate in property right protection presupposes expenditures²⁴. That is why the government will choose participation in the protection if its gross income from improvement of property right protection will be higher than the cost of such protection. When efficiency of private appropriation of private property is low the government will try to evade participation in its protection as the benefits from using the strategic advantages of government protection are low. But the situation changes when the efficiency of private appropriation of private property is high. In this case the better the taxation system and the lower the efficiency of appropriation of the State property the less the State evades participation in the protection of property. Low efficiency of the tax system and high efficiency of the State property appropriation makes evasion more attractive as these factors lower the marginal benefits of the government from resource allocation to property right protection”²⁵.

As the production of protected property rights by the State (provision of services related to property rights protection) is a special case of production of merit goods²⁶, evasion from participation in their production under conditions identified in the study, on one hand, is quite rational for the government, but on the other hand, is feasible only *in the absence of competition on the political market*. If the government evades participation in protection of private property rights, its political opponents will proclaim a *stronger participation of the State in the protection of private rights* and will be able to enter the office. It should be noted that if the expected government costs include the cost of potential loss of authority, the above conclusions will remain true.

²³ Mendoza J. The Protection of Private Property: The Government as a Free-Rider. May 2001 (unpublished manuscript)

²⁴ These costs include not only direct expenses on financing the law enforcement and judicial systems but also a lower income of bureaucrats who have appropriated or intend to appropriate a private business. — *Author’s note*.

²⁵ Mendoza J., op. cit., pp.22-23

²⁶ Merit goods are private or collective goods whose consumption generates significant externalities.

2.3. Economic importance of protection of property and contractual rights

Individual property rights do not guaranty emergence of powerful incentives to *efficient use of such assets*. Only *specified and protected property rights* are a prerequisite of any productive activities²⁷. When such rights are unprotected and attenuated there are no incentives for the most efficient utilization of resources. The owner of unprotected property rights will use such resources with *minimum efficiency* because surplus products (in excess of the survival minimum) can be appropriated without any compensation by any individual possessing a higher potential of violence.

The *logical* rationale of economic importance of property right protection is supported *empirically*.

The earliest research in this area was conducted by P. Mauro²⁸, S. Knack and Ph. Keefer²⁹, R. Barro³⁰ and J. Svensson³¹. Basing on the econometric analysis of cross-country data they revealed rather close links between indicators of quality of national institutions including those supporting the reliability of property right protection, and economic growth rates. Later research based on more exact data³² confirmed the correctness of the earlier studies and conclusions on the importance of property right protection for economic growth. The authors found that poorly protected property rights have a negative effect on investment in both tangible assets (Knack and Keefer, Mauro) and financial assets³³.

There are bilateral relationships between the institutions' quality and economic growth, i.e. "good" institutions positively influence economic growth but slow economic growth might stimulate the search of rent by the State and ruling elites (in the form of corruption, business capture, direct expropriation of investment, etc.). Therefore, inverse relation between economic growth and institutions quality was also the subject of empirical research by a number of authors. According to M. Gradstein³⁴, correlation rates between per capita income and various measurements of institutions' quality in cross-country comparisons are from 0.7 to 0.9. Similar figures were obtained in other studies³⁵.

Common for all above research work is *integral* accounting of national institutions' quality, absence of separate indicators for the level of property right protection and the level of contractual rights protection. This defect was eliminated in the recent work by D.

²⁷ Demsetz H. Toward a Theory of Property Rights // American Economic Review. May 1967. P. 347–359.

²⁸ Mauro P. Corruption and growth // Quarterly Journal of Economics, 1995, v.110, pp. 683-712

²⁹ Knack S. and Keefer Ph. Why don't poor countries catch up? A cross-national test of an institutional explanation // Economic Inquiry, 1997, v. 35, pp. 590-602; Knack S. and Keefer Ph. Does social capital have an economic payoff? A cross-country investigation. // Quarterly Journal of Economics, v. 112, pp. 1231-1288

³⁰ Barro R. Determinants of Economic Growth: A Cross-Country Empirical Study. Cambridge, Mass.: MIT Press, 1997

³¹ Svensson J. Investment, property rights, and political instability: Theory and evidence // European Economic Review, 1998, v. 42, pp. 1317-1341

³² Kaufmann D., Kraay A., Zoido-Lobaton P. Governance matter. World Bank Policy Research WP 2196. Development Research Group. World Bank, Washington, DC. 1999; Chong A. and Calderon C.A. Causality and feedback between institutional measures and economic growth // Economics and Politics, 2000, v.12, pp. 69-82

³³ Demircuc-Kunt A. and Maksimovic V. Law, finance, and firm growth // Journal of Finance, 1998, v. 53, pp. 2107-2137

³⁴ Gradstein M. Governance and Economic Growth. World bank Policy Research Working Paper 3098, July 2003, p.8-9

³⁵ See, for example: Treisman D. The causes of corruption: A cross-national study // Journal of Public Economics, 2000, v.76, pp.399-457

Acemoglu and S. Johnson³⁶. The authors differed between “*property right institutions*” protecting citizens from expropriation by the government and ruling elite and “*contracting institutions*” maintaining private contacts between individuals. A detailed econometric analysis of cross-country data has shown that property rights institutions have priority in influencing *long-term economic growth, investment process and development of financial markets.. Contracting institutions* mostly influence the development of various forms of *financial mediation*.

The authors believe that such different effects of the above types of institutions on economy can be explained as follows: the parties in private contracts are free in choosing the form of contract to avoid negative influence of official institutions of contract protection. At the same time they are unable to avoid or oppose the risk of expropriation of their property by the State and power elite.

2.4. Independence of the judicial system

As it follows from the above provisions, the judicial system plays a very important role in ensuring protection of property rights. This role is defined by the fact that it is the court that *rules on the cases* of property rights violation, chooses the type of *punishment* for the identified offender, and *sets and affirms rights* in disputed cases.

From the point of view of the economics, punishment for the offender in the form of a *fine equal to the amount of damage* dealt by the violation, is more important for creating *incentives* for potential offenders *not to violate property rights in future* than for its *indemnifying function*. In other words, punishment of violations provides for **protection against future violations** (if information on respective punishments is distributed between potential offenders). For an offender knowing that any profit from his actions (use of others’ property rights) will be capped by the fine imposed, *the violation will no longer be a viable option*.

It is important to stress here that for future offenders all the above variables represent *mean value*, i.e., the product of cost/benefits and probabilities (probabilities of successful deriving profit from violation of rights and probabilities of being punished, respectively). As the cost of increasing the probabilities to identify and punish the offender by improving the efficiency of law enforcement bodies is rather high for the State, a more economical way would be to *raise the amount of fine* imposed on the offender making it higher than the damage dealt (it is the common practice).

From the point of view of providing for appropriate deterrence it is not *important* whether the fine is collected in favor of the State or the victim. However, from the point of view of creating necessary *incentives* for the victim to appeal to the court it is advisable to collect the fine *in favor of the victim* because only in this case the cost of appealing to the court will be profitable for the victim (in which case the fine should be the sum of the damage dealt plus litigation costs).

The system of civil justice in any country, being an integral part of its governmental system, has complicated interrelations both with other branches of the government and with a wider social and economic environment. According to the economics, increasing the *productivity and efficiency* of civil justice functioning should have a positive impact on the incentives to use resources in an efficient manner. In its turn, the nature of economic processes, namely, the possibilities for the state budget to finance courts, greatly influences

³⁶ Acemoglu D. and Johnson S. Unbundling Institutions. MIT, Massachusetts, Department of Economics, July 2003 (mimeo)

the level of development and quality of the judicial system, i.e. its effectiveness and efficiency.

In this case we interpret *effectiveness* as the level of success in dispute resolution, i.e. successful protection of violated rights, and *efficiency* as the ratio of results obtained to the related costs. In other words, a judicial system can be effective yet inefficient, and vice versa, efficient but not effective. In the first case rectification of an injustice will be achieved at a very high cost, while in the second case the low cost of maintaining the judicial system will in the final count lead to lower efficiency.

Effectiveness of any country's judicial system is determined by a wide array of factors, in which two can be mentioned specifically: (1) type of the legal framework and (2) level of the judges' independence.

While talking about the *type of the legal framework*, we first of all mean common law and civil law (unified or codified law). In the first case the court *makes* laws (primarily in the area of settling private disputes), in the second case it *enforces* the laws created by the legislative branch. Consequently, effectiveness of courts in the system of unified law depends heavily on what laws were set up by the legislators in the area of rights specification and protection: a court cannot change a law, even when the rules of conflict resolution provide for economically inefficient definition and redistribution of rights.

The influence of the judge independence level on effectiveness is evident: any dispute arises from the conflict of interests of its participants – and all of them have incentives to influence the judge so that the conflict was resolved in their favor³⁷. The current empirical data from more than 70 countries shows a stable and statistically significant positive impact of *real independence* of judges on economic growth³⁸. It is worth mentioning that *formal independence de jure* does not have a statistically significant impact on economic growth³⁹.

Successful lobbying can modify the court ruling which in this case would not be socially effective or providing for maximization of public welfare. Such possibilities exist both in common law and unified law, however, the *first* framework provides more support to economically effective decisions⁴⁰.

As the level of court independence in case of outside influence is decreasing, *accountability* of the court to the law and society becomes all the more important. Empirical analysis based on cross-country comparison⁴¹ shows a positive correlation between *accountability* of the court and per capita GDP. In short, the research based on

³⁷ Buchanan J. Comments on the Independent Judiciary in an Interest Group Perspective // Journal of Law and Economics. 1975. Vol. 18. № 3.

³⁸ Feld L., Voigt S. Making Judges Independent – Some Proposals Regarding the Judiciary. CESifo Working Paper № 1260. 2004.

³⁹ Feld L., Voigt S. Economic Growth and Judicial Independence: Cross Country Evidence Using a New Set of Indicators. CESifo Working Paper № 906. April 2003.

⁴⁰ See discussion of the issue in the following works: Posner R. Economic Analysis of Law. Boston: Little, Brown, 1973; Priest G. The Common Law Process and the Selection of Efficient Rules // Journal of Legal Studies. 1977. Vol. 6; Rubin P. Why is the Common Law Efficient. Also there; Zerbe, R.O., Jr.: Economic Efficiency in Law and Economics. Northampton: Edward Elgar, 2001; Deffains B. Efficiency of Civil Law. ESNIÉ, Corte, 2002. This material is available at http://esnie.u-paris10.fr/pdf/textes_2002/Deffains-Efficiency-of-civil-law.pdf; Rubin P. Why Was the Common Law Efficient? Emory University School of Law. Working Paper № 04-06. 2004.

⁴¹ Voigt S. The Economic Effects of Judicial Accountability. Paper presented at 5th Corsica Workshop on Law & Economics. Marseille, 2004.

the data of several Indian states has shown that *quality* of judicial proceedings, quantitatively assessed by the *speed* and *predictability* of court rulings measured by the share of appeals satisfied by the Supreme Court, has a statistically significant influence on the parameters of social and economic development: the lower the quality, the lower per capita GDP, the higher the share of the poor, etc⁴².

Basing on the presented theoretical provisions and their empirical evidence it can be assumed that an efficient State should be *interested* in establishing an effective and efficient judicial system, possessing such qualities as independence and *accountability* of judges. Economic growth supported by such judicial function ensures an increase in *tax revenue*, i.e. increase in revenue of the State as a special type of an organization.

However, this conclusion will only be correct if an increase in tax revenue from increasing profit ensured by the efficiency of the judicial system will be higher than direct gains of civil servants from the revenue ensured by the courts' *dependence* and *accountability* to the executive authority, not to law or society (see paragraph 2.3).

In Russia, where the statistical data indicates that a significant part of the budget revenue is not provided by *taxes*, we can expect *limited concern of the executive branch* for making an effective and efficient judicial system. Therefore, the issue of drafting proposals aimed to increase the efficiency of the national civil litigation should be closely linked with the problem of *enforceability* of the respective recommendations, i.e. possibilities of their acceptance by legislative and executive bodies.

Improving independence of courts is one of the basic aspects of the judicial reform, and it can be accompanied by certain difficulties arising from the nature of the current governmental system in Russia. This forecast is based on the results of the recent research made by E. Hanssen⁴³, which analyzed the connection between the level of competition on the political market and incentives of the current governing party to create an independent judicial system.

A theoretical model proposed in that research is based on the following assumptions: independent court, i.e. the court whose decisions are not affected by the executive branch, can increase the difficulties of the executive authority in implementation of its policy. For example, it can deem some political decisions as contradicting the constitution of the country, challenge the bylaws adopted by the executive branch, etc. On the other hand, in case of the current governing party's loss during the elections and its replacement by its political opponents an independent court can prevent a radical change of policy making its own assessments and suggestions on the political innovations of the new executive branch which would be contradictory to the previously adopted laws.

Determination of an "optimal" (according to the current administration) level of court independence, which it will strive to achieve, depends, as is evidenced by the above model, on two main factors: probability of losing power and level of differences between the platforms of the competing parties. The research shows that the lower the level of competition on the political market (i.e. the weaker the rivals and, therefore, the lower the chances of losing power) and the closer the platforms of the rivals, the lower the chances to create an independent judicial branch by the executive branch. This conclusion is intuitively understandable: if politicians have low chances of losing power, then the

⁴² Köhling W. The Economic Consequences of a Weak Judiciary: Insight from India. Center for Development Research. University of Bonn. November 2000.

⁴³ Hanssen A.F. Is there a politically optimal level of judicial independence? Montana State University. Department of Economics. June 2002 (mimeo)

difficulties created by an independent court will not be compensated by the protection from possible attacks of the new government. Difficulties will be created *today* while *potential problems* against which court protection will be required, *may not arise at all*: no or weak rivals on the political market (or rivals only formally, due to the lack of differences in ideology and political trends), that there's no need to be protected against them in future.

This hypothesis was formulated by E. Hanssen on the basis of a massive body of data on different political situations emerging in the American states over a long period of time and levels of local court independence provided by the governing parties. The author notes that “as predicted by the model, institutions mostly responsible for ensuring judicial independence (i.e., those with the best capability of preventing civil servants, political parties and other important actors dependant on election results, from affecting the decision-making conditions of judges) appeared to be significantly (statistically and economically) connected with the more severe rivalry between political parties and greater differences between platforms, while institutions providing for the least possible judicial independence appeared to be closely connected with the single-party control”⁴⁴.

Even a superficial analysis of competition on the Russian political market, when compared with the results of E. Hanssen's research, shows that the **judicial independence strengthening policy** can encounter a tough **opposition** on the part of many civil servants of all levels, who are interested in an increasing dependence of judges from them. This constitutes one of the **most substantial risks** in implementing the property rights protection improvement policy.

⁴⁴ Op. cit., p.4