

# Why the Rich May Favor Poor Protection of Property Rights

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## Motivation: Transition Experience

- Russia
  - a command economy 1920-1991
  - a democracy since 1991
- The problem: How to build capitalist institutions?
  - It does not matter who receives large stakes of formerly state property. They will raise demand for protection of property rights.
- Aslund (1995): "... [once] the fundamental issues [of] the mutual independence of enterprises from one another (as well as from the state) and their profit orientation [have been addressed], owners will forcefully try to ascertain their property rights".

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## Reality

- 'Russian oligarchs': a group of wealthy and politically powerful people
  - before privatization made fortunes by taking control of cash flows of state enterprises and obtaining rents from various arbitrage opportunities (fixed prices, multiple exchange rate, export control, etc)
  - after privatization were the main opponents of establishing clearly defined property rights, since they continued to gain from it; instead of lobbying for good institutions for all, each of them tried to build private system to protect his rents
- Stiglitz (2002): *"Today, in Russia, we do not see demands for strong competition policy forthcoming from the oligarchs, the new monopolists. Demands for the rule of law have come from these oligarchs, who obtained their wealth through behind-the-scene deals within the Kremlin, only as they have seen their special influence on Russia's rulers wane."*
- Black (2002): *"Broad private ownership [didn't create] a constituency for strengthening and enforcing [the new Civil and Commercial Codes]. Instead, company managers and kleptocrats opposed efforts to strengthen or enforce the capital market laws. And what they didn't want, they didn't get."*
- Polishchuk and Savvateev (1997), Savvateev (1998)

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## Not Necessarily Russia

- East Asia (Claessens et al, 2000): the largest ten families control (as a share of total corporate assets)
  - Indonesia - 57.7%
  - Philippines - 52.5%
  - Thailand - 46.2%
  - Hong Kong - 32.1%
  - Korea, Malaysia, and Singapore - 25%
  - compared to 2-3% in US and Japan
- Claessens et al (2000): *"The concentration of corporate control in the hands of a few families creates powerful incentives and abilities to lobby government agencies and public officials for preferential treatment, whether through trade barriers, non-market-based financing, preferential public contracts, or other means. Concentration of control might also have been a detriment to the evolution of the countries legal systems."*

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## Why May the Rich Favor Poor Protection of Property Rights?

- Property rights = rights to appropriate privately fruits of own efforts
- A rich agent can protect himself from expropriation, investing into private protection
  - hiring guards and lawyers
  - bribing politicians (to affect regulation)
  - corrupting courts (legal system)
- When a private protection system is maintained, the owner does not need public protection of property rights
- If inequality is high, then a small group of agents gain from redistribution, while the majority loses
- If the political system is skewed toward wealthy, then the situation might be self-sustainable

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## The Model

- A growth model with a continuum of heterogeneous overlapping-generations families
- Each agent
  - lives two periods
  - consumes and invests capital received in first period
  - for second-period consumption, has to invest some capital into production
  - also, has to invest in private protection of productive capital
- The level of public protection of property rights determines efficiency of investment in private protection
  - the better is public protection, the less efficient is investment in private protection = investment in redistribution
  - the more resources agent invests into either production, or private protection, the more capital he/she has after redistribution
  - investment in private protection is wasted for the economy as a whole

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## Technicalities

$$\tau' > \tau, \quad \bar{w} \quad \theta_i^* = \arg \max_{\theta \geq 0} u_i(\theta) \quad \tilde{k}_i = k_i h_i^\theta g$$

$$F((\ln w_m - m) / \sigma) = 1/2$$

$$w_{it+1} = \varepsilon_{it+1} y_{it}, \quad \theta_i^*(\tau') > \theta_i^*(\tau)$$

$$\max_{k_i, h_i} \left\{ \ln(w_i - k_i - h_i) + \rho \ln A(\tilde{k}_i)^\beta w^{1-\beta} \right\}$$

$$\gamma(\theta) = \ln(y/w) = \ln A + \beta \ln p(\theta) - \beta(1-\beta)(1+\theta)^2 \frac{\sigma^2}{2}$$

$$\int_0^1 \tilde{k}_i di = \int_0^1 k_i di \quad k_i^* = p(\theta) w_i, \quad h_i^* = r(\theta) w_i \quad \varepsilon_{it+1}$$

$$y_i = A(\tilde{k}_i)^\beta w^{1-\beta} \quad \theta_i^* \leq \theta_i^*$$

$$\tilde{k}_i = \tilde{k}_i(k_i, h_i; k_{-i}, h_{-i}) \quad w_i \leq \bar{w}$$

$$\lambda \quad F((\ln w_i - m) / \sigma) = \lambda$$

$$\max_{k_i, h_i} \left\{ \ln(w_i - k_i - h_i) + \rho \ln A(\tilde{k}_i)^\beta w^{1-\beta} \right\}$$

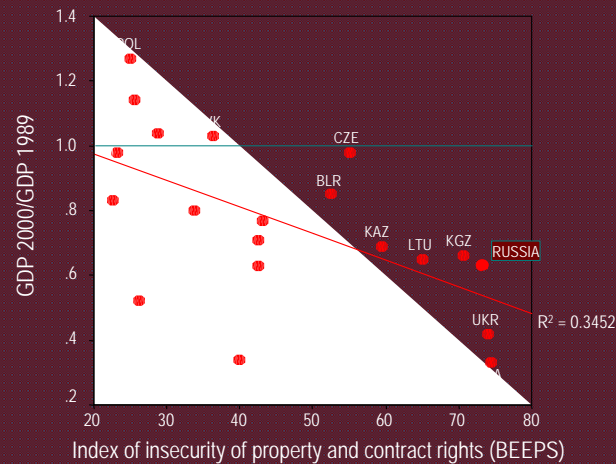
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## Institutions, Inequality, and Growth

- Agent's problem
  - given the level of public protection of property rights, optimize consumption and investment in production and redistribution
- **The better is public protection of property rights, the larger is each agent's investment in production, and the smaller is investment in private protection**
- General equilibrium:
- **The growth rate of the economy is higher, when property rights are better protected; and inequality is lower**
  - inequality harms efficiency in absence of credit markets
  - poor protection of property rights is bad for growth since (a) protection investment is wasted and (b) effect of inequality larger
- **External rents are harmful for growth**

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## Property rights protection and growth (Hoff and Stiglitz, 2004)



The index of insecurity is the fraction of respondents who disagreed with the statement: "I am confident that the legal system will uphold my contract and property rights in business disputes."

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## Natural resources, growth, and property rights insecurity (Hoff and Stiglitz, 2004)

	Fuel and mineral exports/ total exports	2000 GDP/ 1989 GDP	Percent who believe legal system will not "uphold my contract and property rights in business disputes"	Wall Street Journal Rule of Law index (10 = best, 0 = worst)
Average for countries with less than 10% natural resource exports	6.81%	89%	40%	7.5 score
Average: 10 - 20%	15.22%	84%	42%	6.9 score
Average: greater than 20%	41.86%	66%	68%	4.2 score
<b>Russia</b>	<b>53.15% (1996)</b>	<b>63%</b>	<b>73%</b>	<b>3.7 score</b>

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## Demand for Institutions

- Each agent has preferences over the level of property rights protection
  - given his/her optimal decisions
- **The richer is an agent, the less public protection he/she prefers**
  - the rich are more effective in private protection, than the poor, and so they demand less public protection
- **The higher is the productivity of production ( $\beta$ ), the more valuable is the second-period ( $\rho$ ), the higher is inequality ( $\sigma^2$ ), the higher level of public protection each agent prefers**
  - inequality impact is due to specific technical assumptions (log-normal distribution of wealth)

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## Political Economy

- Agents' individual preferences are aggregated within some political system
  - in an ideal democracy, it is majority voting (and so the outcome is determined by the median voter)
- General political system
  - the level of property rights protection is determined by the pivotal voter, who represents the  $\lambda^{\text{th}}$  wealth percentile
- **The more wealthy is the pivotal voter (the more 'skewed' is the political system toward), the lower is the aggregate demand for public protection**
  - a rich pivotal voter is more likely to gain from redistribution due to poor protection of property rights

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## Multiple Equilibria

- ***If the pivotal voter is rich enough, then his/her choice of the level of public protection of property rights increases inequality (within the next generation)***
  - redistribution is in favor of rich
- ***For any pivotal voter, an increase in inequality raises demand for public protection***
  - with increased inequality, the same voter becomes relatively poorer, and therefore demands more public protection
- ***If the political system is skewed enough, there exist multiple equilibria, with the 'bad' equilibrium characterized by high inequality, low public protection, and low growth rate***
  - contrary to expectations that the economy necessarily ends up with the full protection of property rights

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## King John vs. Robin Hood

- King John's redistribution
  - From poor to rich (e.g., through subversion of institutions = poor protection of property rights)
- Robin Hood redistribution
  - From rich to poor (progressive taxation, social benefits, etc.)
- ***For any tax rates  $t' > t$  and any pivotal voter who is rich enough, the level of public protection of property rights is lower for  $t'$*** 
  - if the pivotal voter is rich enough to lose from Robin Hood redistribution (progressive taxation), then he tries to offset losses by King John redistribution
  - if the tax rate is above the growth-maximizing level, then lowering taxes improves public protection

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## Development

- ***Journal of Comparative Economics, 31 (2003), 715-731***
  - Symposium issue on New Comparative Economics, S.Djankov and A.Shleifer, eds.
- Glaeser, Sheinkman, and Shleifer (2003)
  - technological change => increase in inequality => subversion of institutions => reforms
- Hoff and Stiglitz (2002)
  - external shocks can help in switching equilibria
- Berglof and Bolton (2002)
  - political demand for property rights and financial development
- Braguinsky and Myerson (2003)
  - local oligarchs versus outsiders
- Roland (2000, 2002)
- Gradstein (2004)

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## Conclusion

- In unequal societies, the rich can shape institutions in their favor
- If protection of property rights by the state is weak and there is economy of scale in private protection of property rights, the rich gain from redistribution
- If the rich control the political system, there is no pressure for more public protection of property rights
- Poor protection of property rights is bad for growth
- An economy may be stuck in 'bad' long-run equilibrium with low growth rate, high inequality, and low level of public protection of property rights

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