Out of Chaos?
Russian Business Conflicts and Demand for the Rule of Law

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Chapter 1

Demand for Law

In recent years social scientists, legal scholars, and policymakers have converged on a near consensus that institutions—particularly those that protect property rights and enforce contracts—are essential to economic growth and societal wellbeing (e.g., Acemoglu et al. 2001; Cooter and Schaefer 2008; de Soto 2003; Knack and Keefer 1995; North 1981; Posner 1998; World Bank 2002). Yet despite recognition of the importance of property rights, scholars are only beginning to identify the rare historical and political conditions under which institutions that effectively protect property rights emerge. The most influential studies focus predominantly on the conditions under which rulers and governments face incentives to provide secure property rights (e.g., Acemoglu and Robinson 2006; North 1981; Olson 1993).[1] When and why states "supply" institutions is undoubtedly an important question, but equally pressing is the issue of when and why private sector actors "demand" property rights (Hendley 1997, 1999, 2001; Pistor 1996, 1999; Yakovlev et al. 2004). If businesspeople perceive state institutions as unnecessary or ineffective, they are prone to circumvent or subvert them. As a result, institutions atrophy or become disengaged from the informal rules governing economic transactions.

[1]There is also an ample literature on how firms protect property and adjudicate disputes in the absence of effective state institutions (e.g., Greif 1993; Haber et al. 2003; McMillan and Woodruff 1999).

In the literature on property rights, the demand side of institutional formation has been relatively neglected. Instead, analysts have perceived rulers to be the primary obstacle to institutional development, and prominent studies have thus focused on rulers' rationales for facilitating or undermining the security of property rights. These studies emphasize factors such as rulers' relative bargaining power *vis-à-vis* constituents, the effectiveness of technologies for monitoring and taxing assets, rulers' expectations about how long they will remain in power, and the degree to which rulers fear economic growth will destabilize their control of a polity (e.g., Acemoglu and Robinson, 2006; North, 1981; Olson, 1993). To the extent that private sector actors enter these analyses, they are portrayed as *inherently* supportive of institutions that protect property rights. For example, North and Weingast's (1989) seminal analysis of the Glorious Revolution in 17th century England contends that a nascent capitalist class mobilized to constrain arbitrary confiscation of assets by the king.

There is ample logic to support the assumption that private sector actors seek the development of institutions protecting property and enforcing contracts. As holders of capital and productive assets, they presumably benefit most from secure property rights. Assets are worth more when one can reasonably expect that property will not be arbitrarily expropriated, and when efficient and enforceable contracts facilitate the transfer of assets to new owners. But are capitalists always supporters of legal institutions and property rights? Or, as the experience of many post-communist countries indicates, is this a story specific to the history of the West?

If the assumption that private sector actors inherently support institutional development is abandoned, the inadequacy of the ruler-centric approach to the study of property rights becomes readily apparent. Existing studies assume that if institutions are "supplied," then private sector "demand" will automatically follow. By

contrast, this study emphasizes that upon the creation of new institutions, firms rarely submit immediately to the revised rules of the game. As discussed below, it may be to their advantage to instead circumvent or subvert formal institutions. It thus becomes critical to examine the factors that shape firms' actual on-the-ground practices for protecting their assets and enforcing contracts. This is an especially important issue in transition and developing countries, where formal institutions are often transplanted wholesale based on foreign models that may be at odds with entrenched ways of doing business.

Consequently, a complete theory of property rights protection cannot end with the ruler's decision to protect or expropriate property rights, nor even with the lobbying of private sector actors for or against institution building. A comprehensive theory must also address the issue of the conditions under which firms turn toward state institutions for protection, leading to the rare convergence of de facto practices and formal rules.

1.1 Demand for Property Rights in Russia

This study analyzes the emerging demand for institutions that protect property rights among Russian businesspeople, with the aim of drawing lessons about the politics of economic development, the origins of market economies, and the process of state building. Russia is a particularly appropriate case for such analysis. At the outset of the 1990s, Russia's economic reformers posited a theory of institution building explicitly based on demand for law. They argued that privatization of state-owned enterprises would create a new class of private owners, who would then lobby the state to create institutions that protect property rights and enforce contracts (Boycko and Shleifer 1995; Shleifer and Vishny 1998).

The asset stripping, criminality, and collusion among tycoons and politicians that

followed privatization led to widespread criticism of this prognosis. During much of the 1990s, businesspeople perceived formal legal institutions to be ineffectual and ill-suited to the realities of the Russian business world (Hendley 1997). Meanwhile, reliance on private coercion—such as criminal protection rackets and private security agencies—to adjudicate and resolve economic conflicts was extensive (Skoblikov 1997; Volkov 2002). Far from promoting secure property rights and orderly transactions, Russia's new business class appeared to threaten legality and public order (Black et al. 2002; Hellman 1998; Hoff and Stiglitz 2004).

In recent years, however, Russian entrepreneurs and industrialists have increasingly utilized and supported the development of formal institutions that protect property rights, reinvigorating debates about whether privatization had created a "rule of law lobby," albeit in delayed fashion.[2] For example, the number of court cases heard in Russia's commercial courts more than doubled over the last 10 years (VAS 2009), while violent resolution of business conflicts became a rare exception. Meanwhile, business associations and powerful business magnates played a significant role as Russia amended or developed anew a host of legislation, including new tax, civil, criminal, and arbitration procedural codes, as well as laws on bankruptcy, joint-stock companies, limited liability companies, and securities markets (Jones Luong and Weinthal 2004; Lazareva et al. 2007; Markus 2007). In short, the Russian experience provides clear evidence that the business sector *can* provide a strong source of demand for institutions that protect property rights, but that there is nothing automatic about this support.

This study aims to resolve these contradictory depictions of Russia's new business class. The seemingly irreconcilable images of the Russian business class as the

[2]See, for example, Boone and Rodionov (2002), Treisman (2002), and Zhuravskaya (2007); for skeptics, see Barnes (2003) and Schwartz (2006, ch. 11).

social cornerstone of the rule of law (by some accounts) and as ruthless rent-seeking outlaws (according to many others) can be reconciled by abandoning the misleading perspective that firms are *either* supporters *or* opponents of institutions that protect property rights. Rather, in transition and developing countries, the business sector's support for legal institutions is *conditional*, as countervailing incentives shape firms' preferences with respect to the development of legal institutions. On the one hand, these institutions protect firms and enable them to conduct business with lower transaction costs. On the other hand, these institutions constrain firms, limiting the types of strategies they can employ. For example, strategies such as taking the assets of a competitor by force or accelerating the resolution of a dispute by bribing a government official become more risky and costly.

The dramatic transformation of the Russian business environment over the last two decades offers a unique opportunity to evaluate propositions about the conditions under which private sector actors utilize formal state institutions to protect their assets. Moreover, whereas studies of property rights have traditionally exhibited a historical focus (e.g., Greif 1993; North and Weingast 1989), Russia today permits firsthand observation of a contemporary process of state formation. Finally, Russia is a fitting example of a "hard case," in the sense that culturally and historically, Russia is often seen as infertile ground for the development of property rights. Understanding conditions under which demand for law takes root in a hostile environment like Russia should offer insights into how legal institutions develop in a wide range of countries and political settings.

1.2 Property Defense Strategies

In any economy, firms face a variety of disputes over control and ownership of assets, both with other firms and with government authorities. Conflicts among private

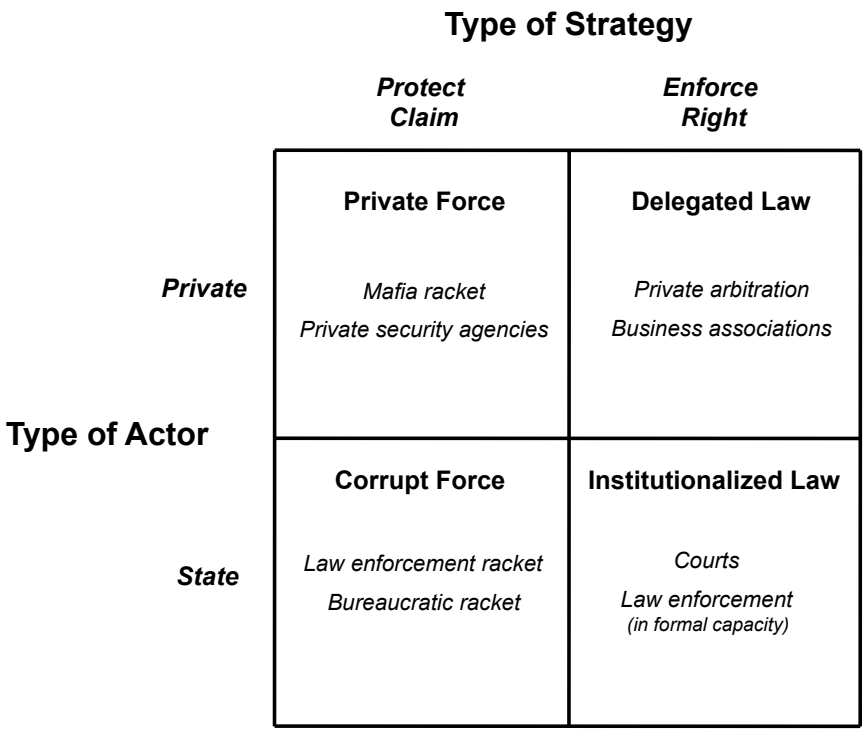
actors may involve contract violations, disputes over debts, inter-firm conflicts over assets, or conflicts among shareholders of a given firm. Conflicts between firms and the state include tax disputes, problems with licenses and permits, clashes with inspectors and regulators, harassment from law enforcement officials, or outright attempts to expropriate a firm's assets. Collectively, I refer to firms' efforts to resolve such conflicts as *property defense*.[3]

As discussed above, a comprehensive theory of property rights requires an understanding of the conditions under which firms rely on formal state institutions. This requires analysis of the property defense *strategies* firms use to protect assets. Even when the best intentioned rulers write laws, build judicial and law enforcement institutions, or promote legal reforms, this does not guarantee that private sector actors will respond as intended. Firms may circumvent formal institutions altogether and turn to private force to resolve disputes. Alternatively, they may subvert formal institutions through bribery and political connections, turning the law into a selectively applied and highly potent weapon against competitors.

When firms submit to the formal rules of the game, a fundamental transformation occurs: the transformation from protecting a property *claim* to enforcing a property *right* (see Winters 2011; also see Cole and Grossman 2002). This transformation is of critical importance for the emergence of the formal institutions that govern modern market economies. Individuals, organizations, and communities throughout history have wielded force to accumulate and protect property claims. On the other hand, the very concept of "rights" presupposes the existence of the modern state, which publicly codifies the law, identifies citizens' privileges and obligations, and establishes the distinction between legitimate and illegitimate ownership. These accomplishments are vital prerequisites for creating the delineation between the legal and illegal use

[3]The term is borrowed from Winters' (2011) seminal work on oligarchs.

Figure 1.1: Property Defense Strategies



of coercion that is central to the distinction between protecting claims and enforcing rights. Whereas protecting a property claim relies on *force* (or the threat of force) without reference to legality, enforcing a property right relies on *law*. Reliance on law does not preclude the use of violence, but it implies that should application of coercion become necessary, it will be coercion legitimatized by formal rules and regulated by the state.

If the existence of a modern state is a necessary condition for the formation and enforcement of property rights, it is nevertheless far from a sufficient condition. The case of Russia and many of its post-Soviet neighbors illustrates that even in polities with a highly developed state apparatus, private actors utilize a broad array

of property defense strategies, as depicted in Figure 1.1. On the one hand, a firm can rely on private actors with the capacity to wield violence to protect property claims. The classic example of *private force* in the Russian case are the criminal protection rackets and private security agencies that played a vital role in property defense in the early 1990s. It has not been lost on observers that these strategies based on private force exhibit many parallels to the private protection on which merchants in pre-modern Europe relied (Volkov 2002). Force can also be applied, however, by state actors. In Russia, protection rackets provided by bureaucrats and law enforcement officials largely replaced criminal protection rackets by the late 1990s. For a fee, these protection rackets used state resources at the behest of private clients to provide security, resolve disputes, and even raid their clients' competitors. Because these protection services' use of state resources for private gain violates formal rules and undermines the distinction between legitimate and illegitimate coercion, they can best be labeled as a strategies of *corrupt force*.

When firms turn to the law in place of force, they similarly have both private and state options. In even the most developed economies, non-state actors play a significant role in enforcing property rights. For example, parties to a conflict voluntarily enter into private arbitration, but the process is in part effective because its outcome is often legally binding and therefore, as a last resort, enforced by the state's legitimate levers of coercion. Business associations regularly provide another form of private property rights enforcement, sorting out disputes among their members. In these cases, state actors and institutions are not necessarily directly involved, but the effectiveness of these strategies resides in the fact that the state has delegated authority to private organizations so that they can assist in resolving property rights disputes. In other words, this is a strategy of *delegated law*. Finally, firms have the option of turning directly to the formal institutions of the state — courts, regulatory

officials, and law enforcement agencies — to enforce property rights, a strategy I refer to as *institutionalized law*.

The classification of property defense strategies presented in Figure 1.1 shares some commonalities with the dichotomies that appear frequently in other studies of institutional development: illegal vs. legal, informal vs. formal, and private vs. public. While these contrasting pairs of traits capture an important element of the transformation from an unlawful to a law abiding environment, they are insufficient for the purposes of this study. For example, it is common to use terms such as "informal" and "private" interchangeably, but then it becomes difficult to conceptualize strategies such as private arbitration that rely on private actors yet have formalized procedures. Likewise, while neither reliance on a mafia racket nor an informal business negotiation involves state actors, it is misleading to include them in a single category of "private" strategies; one is illegal, and one is not. The richer, multi-dimensional typology offered here allows for a fuller examination of the types of transformations underway in countries like Russia.

The outcome — the dependent variable — this study seeks to explain is the shift in firms' strategies from protecting claims to enforcing rights. I leverage variation in strategies (1) over time and (2) across different types of firms in order to examine the factors that underlie this transformation. As discussed in Chapter 2, contrary to popular perception and to a great deal of academic work, there has been a dramatic and extensive increase in firms' demand for law in Russia. Firms reliance on institutionalized law has been growing and continues to grow. Delegated law strategies, while less widespread, are also gaining popularity. Meanwhile, the use of force has not disappeared entirely but it has changed forms: private force has almost entirely been abandoned as a viable strategy, replaced instead by the use of corrupt force.

Whether firms use force to protect property claims or law to enforce property rights has implications for the functioning of the economy and the development of the state. Protecting claims usually undermines or subverts formal state institutions. Enforcing rights, by contrast, usually complements or reinforces formal state institutions. The concluding chapter of this study examines the relationship between firm strategies and state building in greater detail.

1.3 Demand for Law and State Capacity

This study examines demand for law on the part of Russian firms. This is, in a manner of speaking, only half of the story regarding the development of institutions that protect property rights. The threat to property rights is twofold—too weak of a state allows strong private actors to devour the assets of others, but too strong of a state creates a threat to property in its own right (Weingast 1995, 1). The focus here on the "demand side" of institutional development is justified for several reasons. First, as noted at the outset, prominent studies have devoted a disproportionate amount of attention to the "supply side" (e.g., Acemoglu and Robinson 2006; North 1981; Olson 1993). Much less is known, however, about the factors that facilitate demand for institutions that protect property rights.

Second, while demand for law is only part of the story, it is an extremely vital part. When private sector actors use property defense strategies that circumvent or subvert formal state institutions, even the most reform-minded leaders will fall short. The implications of this observation for understanding state capacity — the ability of state actors to implement policies — are far-reaching. Like prominent studies of property rights, many classic studies of state capacity consider the perspective of political leaders and government officials (Evans, Rueschemeyer, and Skocpol 1985; Geddes 1994; Zysman 1983). Whether focused on strategic interaction among state

actors or on the opportunities and constraints presented by states' unique historical trajectories, these studies emphasize factors emanating from within the state itself. On the other hand, Evans (1995), Migdal (1988), and Putnam (1993) draw attention to the fact that states' success or failure is not entirely of their own making. When societal institutions build trust and facilitate information flows, states are more likely to succeed; when societal norms are at loggerheads with the formal rules imposed by the state, or when social organizations resist the expansion of state influence, then states are more likely to fail.

This societal side of state capacity has implications for the effectiveness of nearly all state institutions, but it is especially relevant for institutions that protect property rights and enforce contracts. For one, the extent to which private actors tend toward rule-bound behavior has significant ramifications. When private actors play by the established rules of the game instead of expropriating each other's assets by force or guile, the burden on law enforcement officials and state regulators becomes more manageable. Perhaps more importantly, the effectiveness of legal institutions depends on societal demand to a greater degree than many other types of state institutions. Litigation, after all, is instigated largely by private parties. Moreover, laws and legal institutions matter only to the extent that private sector actors believe that they matter for *other* private sector actors. That is, laws and legal institutions become effective only when a critical mass of society chooses to use and respect them, an issue I explore in greater detail in Chapter 3.

State-provided legal institutions thus face a greater risk of irrelevance than other types of state institutions. Indeed, commercial courts in early modern Europe often operated entirely outside the auspices of the state. Over time, state courts had to compete with non-state counterparts to convince merchants to settle their disputes in state-provided venues (Benson 1989; Berman 1983, 339-355). In this sense, when

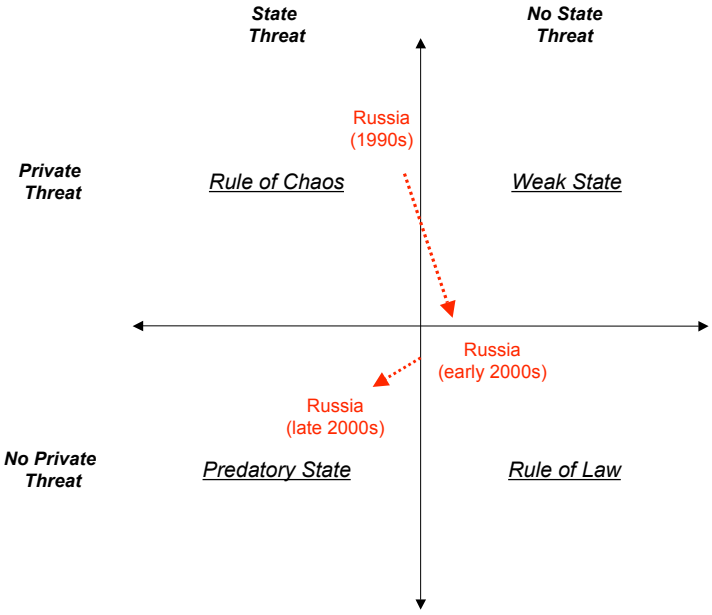
private sector actors demand law, they are participating in the building of the state. Insights into the factors that stimulate private sector demand for law are thus insights into how a critical part of state capacity gets built.

1.4 Demand for Law vs. The Rule of Law

Demand for law — the focus of this study — is a necessary but not sufficient element in building the rule of law. Without it, property rights and contracts will not be secure, but the full rule of law requires putting a leash on state threats as well. As discussed in the preceding sections, demand for institutions that protect property rights in Russia has increased over the last decade and a half, and the private threat to property rights has concomitantly declined. The same cannot be said of state threats to property rights. Upon the transfer of power from Boris Yeltsin to Vladimir Putin at the end of the 1990s, there was a significant improvement in stability and order, leading to a brief period in which hope for the rule of law seemed justified. Since then, however, state threats to property have grown. Large companies have faced pressures to sell assets, especially in the natural resource sector, to companies owned by the state or under the thumb of state officials. Lower level bureaucrats, incited by the attack on businesses they have witnessed at the highest levels of powers, have come to view small and medium-sized businesses as a personal source of rents. In the last couple of years, law enforcement officials have begun to use criminal investigations to force business people to cough up "protection payments."

Figure 1.2 depicts the dual threats to property rights, with specific reference to Russia. The *rule of chaos* combines private and state threats, as with Russia in the early 1990s, or with pre-modern Europe. Private threats but reprieve from state expropriation results when a *weak state* cannot regulate or overpower private actors. Russia by the mid-to-late 1990s, with its powerful business tycoons, often referred

Figure 1.2: State vs. Private Threats to Property Rights



to as "oligarchs," was heading in this direction. Meanwhile, the absence of both private and state threats is the relatively rare situation in which a society tends toward the *rule of law*. As noted, Russia briefly showed such tendencies in the early 2000s, a period during which Putin brought stability and yet retained some control over predatory state bureaucrats. However, reprieve from private threats combined with grave threats from a *predatory state* is increasingly the situation Russia finds itself in today. Although this study focuses primarily on private sector demand for law, the interaction between state and private actors is a central component of institutional development. Consideration of changes in the Russian state therefore enter the analysis throughout the study.

Naturally, the rule of law encompasses much more than institutions that protect property rights and enforce contracts. Among many other constitutive elements,

essential aspects of the rule of law include institutions that hold political leaders accountable, protect human rights, and offer the criminally accused due process. Property rights are, nonetheless, the cornerstone of modern market economies, and thus are a justifiable starting point for those seeking to understand the political foundations of the rule of law. Arguably, the demand for property rights also serves as a springboard for more extensive demands for law, an issue to which I return in the concluding chapter.

1.5 Methodology

The analysis in this study is based on a wide range of methods and data: (1) in-depth qualitative interviews, (2) formal modeling, and (3) an original survey of Russian enterprise managers across eight cities. Throughout 2009, I conducted 90 interviews with Russian businesspeople, lawyers, and private security agencies (further details about the sample are presented in Appendix 1), as well as supplementary interviews with representatives of business and legal associations, business journalists, and Russian academics. These interviews addressed the ways that firms resolve conflicts with other firms, such as non-payment problems and contract disputes; the ways that firms resolve conflicts with the state, such as tax or regulatory disputes; the extent to which firms are willing to use Russia's court system and the types of legal resources they employ; and the degree to which firms use private security agencies as opposed to official law enforcement agencies. To assess the validity of my interview data, I additionally collected caseload data from the Russia Supreme Arbitrazh Court, crime statistics from the Russian Ministry of Internal Affairs, and relevant surveys from a variety of Russian research organizations.

These interviews form the basis for the modeling component of my research, which employs evolutionary game theory (EGT) to analyze the progression of firms'

strategies for resolving business conflicts from the early 1990s through the present day. My field research indicates that EGT is a more appropriate tool than traditional non-cooperative game theory for a number of reasons. EGT does not require strong rationality assumptions on the part of firms nor does it assume that firms always make strategic choices based on expected payoffs. Instead, the focus of analysis is on which types of firms will be more likely to survive, given their chosen strategies. Indeed, my field research indicated that with the exception of very large firms, decisions regarding conflicts and security are often based more on emotional considerations, such as a desire for revenge against a competitor or a sense of whether a provider of security can be trusted. Moreover, even when firms try to act strategically, they are bound by many factors. For instance, if a mafia racket wants to "protect" a firm, the businessman does not in any true sense choose to accept this protection or not.

The EGT framework additionally captures one of the key dynamics of the development of demand for law: A firm's benefit from using legal strategies increases as other firms adopt legal strategies. There exists a tipping point at which a society begins to break from a vicious cycle in which non-legal strategies engender the use of more non-legal strategies and move into a virtuous cycle in which legal strategies foster the adoption of additional legal strategies. EGT facilitates analysis of the factors that shift this threshold up or down.

In an iterative process, I test the predictions generated by fieldwork and modeling using survey data, caseload data, and a variety of qualitative sources, such as the Russian business press. In summer 2010 I conducted an original survey of 300 Russian firms from eight cities: Moscow, St. Petersburg, Nizhniy Novgorod, Ekaterinburg, and Novosibirsk, Rostov-on-Don, Samara, and Kazan. The survey questions mirrored the in-depth interview questions but were closed-ended to encourage uniform, comparable answers suitable for statistical analysis. Additionally,

to the extent possible, I have gained access to the survey data on Russian firms collected by other researchers (as shown in Appendix 1, I have acquired four data sets, collected between 1997 and 2008).

1.6 Chapter Overview

The remainder of this introduction provides an overview of the argument via an outline of the study's chapters.

Chapter 2: Organizing Chaos

Chapter 2 examines the evolution of firms' property defense strategies in Russia. High-profile cases of property rights abuses dominate journalistic, policymaking, and many academic accounts of Russia, leading observers to conclude that Russia remains a lawless land (e.g., Browder 2009; Edwards 2009; Hoff and Stiglitz 2008). I find, however, that the majority of Russian firms today rely much more extensively on law than on force. A transformation from protecting property claims to enforcing property rights has occurred, and to the extent that force rather than law continues to play a role, corrupt force has replaced private force. Four notable trends are:

1. *Decreased private force*: In the early to mid-1990s, Russian government authorities estimated that as many as one-half of Russian firms were under the protection or utilized the "services" of criminal protection rackets. The use of private security agencies to enforce contracts and adjudicate business disputes was also widespread. By contrast, the survey conducted as part of this study indicates that less than five percent of firms report contact with criminal rackets over the last three years. Interviews and survey evidence further indicate that violent means of resolving business disputes are largely a phenomenon of the past and that the role of private security

agencies has been transformed. Security firms in contemporary Russia primarily provide basic physical protection of buildings, cargo, and business executives—much like security firms in the West.

2. *Persistence of corrupt force*: As Russian firms' turned away from private force in the mid to late 1990s, they began to utilize property defense strategies that relied on the corrupt appropriation of state resources. Foremost among these was the protection rackets offered by law enforcement officials. Another prominent tool based on the corrupt use of state resources that arose in the mid to late 1990s was the "ordered inspection" (*zakaznoj naezd*), in which firms paid government bureaucrats and law enforcement officials to selectively conduct tax, fire, sanitation, or even criminal inspections in order to pressure competitors or counterparties in a dispute. The survey conducted as part of this study offers evidence that property defense strategies involving corrupt force persist to the present day, intermingling with the legitimate use of formal state institutions.

3. *Development of delegated law*: In the 1990s, firms rarely used property rights enforcement strategies that rely on private organizations, such as business associations or private arbitration. While compared to developed economies, the enforcement of property rights by private actors in Russia remains underutilized, there is evidence that this is beginning to change. Many firms — especially small and medium sized enterprises — have begun to rely on business associations as a source of legal advice and protection from property rights abuses, particularly by government officials. Similarly, private arbitration as a tool for resolving economic conflicts is gaining popularity in the Russian business world.

4. *Increased institutionalized law*: In the early to mid-1990s, few firms relied on lawyers and courts. By contrast, caseload data, surveys, and interviews all indicate

that law plays a major role in contemporary Russian business. From 1994 through 2009, the number of cases decided in Russias commercial courts rose by over 300 percent. Interviews and survey evidence conducted for this study confirm that this increase is due to firms' rising willingness to resolve disputes through negotiations among lawyers or via litigation, rather than to increased conflict among firms.

In summary, while the use of force has not entirely disappeared, firms' property defense strategies have evolved considerably since the 1990s.

Chapter 3: What is Law? A Micro-Level Analysis from the Firm's Perspective

Chapter 3 develops an analytical framework for understanding how firms select property defense strategies. It combines formal modeling with insights drawn from in-depth interviews of Russian businesspeople, lawyers, and private security firms. Whereas analysts often treat laws and legal institutions as public goods that make all participants in the economy better off, my research reveals the countervailing incentives that legal institutions impose on firms. On one hand, effective courts and law enforcement agencies make economic transactions more predictable and property more secure; on the other, they constrain the strategies firms can use to acquire and protect assets.

A Siberian entrepreneur's response to the question of whether it is easier or more difficult to do business today than ten years ago succinctly captures these conflicting incentives: "It is easier — because there are more laws. And it is harder — because there are more laws" (author interview, 28 September 2009, 092809-F51). For instance, institutional development reduces a firms security expenses but also makes it riskier to bribe law enforcement officials to turn a blind eye when acquiring a competitors assets through illegal means.

The framework examines two aspects of the process whereby firms come to comply with formal institutions. The first aspect involves *direct effects*: the change of exogenous factors that shape the relative costs and benefits of circumventing, subverting, or complying with formal rules. The second aspect pertains to *interactive effects*. Because compliance involves the interplay of numerous actors, the extent to which compliance exists in the overall economy naturally affects the benefit which an individual derives from also complying.

Chapter 4: Stimulating Demand for Law

Drawing on the analytical framework developed in Chapter 3, this chapter examines the factors contributing to firms' shift from force to law. Based on in-depth fieldwork interviews along with quantitative data from surveys of business people, this chapter focuses on the evolution in property defense strategies over time. This analysis examines socioeconomic, institutional, and firm-level factors that influence the benefits and constraints that formal legal institutions impose—and thus ultimately how firms choose to resolve disputes.

Socioeconomic Factors

Economic Development

The early 1990s in Russia was a period in which the physical control of factories and machinery was at stake. Today, transaction and asset battles have become more complex, making cruder methods of enforcement and property rights protection unrealistic. Mafia enforcers and private security agencies may excel at handling ownership disputes that involve physical assets, especially during chaotic times, but when ownership disputes involve complicated mergers and acquisitions, businesspeople by necessity turn to lawyers. Additionally, as business in Russia has become inter-regional, it has become harder for companies to rely on connections and en-

forcers, which are almost by definition local. Finally, the increasing separation of management and ownership in large Russian firms is leading powerful tycoons—who having consolidated assets no longer want to run their businesses on a day-to-day basis—to support laws and institutions ensuring that their managers do not expropriate their resources.

In research interviews, many respondents also cite the fact that in the 1990s, there was nothing to lose. At the time, many people involved in business were young and had no families and little wealth. Today, the situation is different. In the words of one lawyer, "You can risk in business, but not in life" (author interview, 4 March 2009, 030409-L3). In this sense, the exogenous burst of economic growth that resulted from high oil prices in the early to mid-2000s in many ways had a beneficial effect on private sector actors' demand for law and formal institutions, as it put assets in the hands of a broader swath of the population and shifted the relative attractiveness of investment as compared to expropriation. As a businessman in Moscow told me, "Why extort a kiosk when you can open a chain of retail stores?" (author interview, 20 March 2009, 032009-F11). Even more fundamentally, the influx of wealth into the economy, combined with institutional changes discussed below, meant that many businesspeople for the first time since the fall of the Soviet Union had the resources to avoid arrears and pay taxes. This allowed them to at least partially come out of the informal sector—an essential prerequisite to using formal legal institutions given that firms operating illegally avoid turning to the court system.

International Factors

In contrast to the development of law and legal institutions in Western Europe and North America, institutional development in post-Soviet economies is occurring in a globalized environment in which multinational corporations, international legal

frameworks, international financial institutions, and cross-national financial flows have a significant impact. Representatives of larger companies repeatedly state in interviews that a motivating factor for conducting lawful business and undertaking corporate governance reforms is the prospect of carrying out an IPO on a foreign stock market or attracting FDI. They realize that to succeed on international capital markets, they need to settle whatever legal issues remain from a shady past and prepare for the scrutiny of extensive due diligence investigations.

International economic incentives are not the only way that the international environment has an impact on the way firms settle disputes. In contrast to early capitalists in pre-modern Europe, businesspeople in post-communist countries have a very clear sense of what "developed" capitalism looks like. In Russia they talk constantly of creating more "civilized" forms of businesses. Government officials and academic experts spend a great deal of time studying the institutions of developed economies, and institutions such as the World Bank and American Bar Association actively support the dissemination of Western legal and economic practices. The fact that a template of effective capitalism and lawful societies exists in Russian businesspeoples' minds powerfully affects their actions. They recognize that the legal system is taking root and that they may be held responsible for past actions, even if today it's possible to get away with a given tactic.

Institutional Factors

Development of the Courts and Legal Framework

Demand for legal institutions depends in part on the quality and accessibility of legal institutions, and these "supply-side" factors have been dynamically evolving in Russia. Unlike developing countries in which inadequate institutions have languished for decades, market-supporting institutions in Russia and other post-communist

countries were created almost from scratch upon the fall of communism. They were fundamentally alien to businesspeople, and court officials themselves lacked experience adjudicating the types of conflicts that arise in a market economy. The learning curve over the first post-communist decade was thus extremely steep. Numerous interviewees report that faith in the courts has risen simply for the reason that judges are now better qualified, better paid, and more experienced than in the 1990s. Corporate legislation continues to improve and the Supreme Arbitration Court, which commands great respect among respondents, has provided extensive commentary clarifying previously grey areas in the law. Institutional changes, such as additional layers of appellate courts, have reduced the potential for corruption, as lower-level judges worry about having their decisions overturned.

Interaction with Other Reforms

According to respondents, policymakers, and experts, tax reform is essential for development of formal legal institutions. As long as firms are unwilling or unable to pay close to a full share of their taxes, they are afraid to turn to law enforcement and the court system because coming out of the shadows will create more problems than it will solve. They are thus forced to rely on private force for protection and adjudication of conflicts. Banking reform is similarly crucial. Since the early 2000s, the Russian government has sought to increase confidence in the banking sector and has taken measures to limit cash transactions. Cash flow is essential for paying bribes and instigating illegal operations against competitors. To the extent that cash transactions are reduced, the more firms are forced to find legal and formal ways to deal with disputes. A third critical issue is higher education reform, specifically with respect to law and business schools. Business people cite the fact that qualified lawyers and judges now exist as a key to why they are more willing to use courts.

They also credit their own increased knowledge of how legal businesses are run and about laws pertaining to business, and this is especially true for people who have MBAs.

Firm-Level Factors

Corporate Raiding and Predatory Bureaucrats

Much attention has been paid to the dubious legal schemes—known as raiding (*reiderstvo*)—in which businesspeople and criminals rely on abuses of the judiciary and state bureaucracy to obtain assets at below market prices (Firestone 2008; Volkov 2004). It is true that such abuses to an extent undermine the judiciary and in some cases discourage the creation or expansion of businesses. But less attention has been paid to the ways in which corporate raiding and predatory bureaucrats can also become a strong motivating factor for businesspeople to learn and follow the law. Both raiders and bureaucrats seek cheap and easy prey. Raiders especially do extensive research to identify their targets. Broken laws or regulations, unpaid taxes, or improperly filed corporate documents make a company vulnerable. Numerous businesspeople cite the risk of raiders and government inspections as a major reason to follow the law. Being law abiding does not guarantee a company's security, but not doing so makes one a much more likely target. In the words of one entrepreneur, abiding by the law is a "necessary but not sufficient source of protection" when doing business in Russia (author interview, 17 February 2009, 021709-F2). As firms become better prepared, the cost of raiding rises, reducing abuses of the judicial system.

Balance of "Coercive" Resources

During the 1990s, racketeers, private security agencies, and corporate security departments provided non-state protection and contract enforcement to firms. In

an environment in which only some firms possessed protection, those with greater coercive resources reaped profits. But as stronger groups destroyed or subsumed weaker ones, those that remained were more evenly matched, making violent resolution of conflicts less lucrative. Similarly, as firms began devising ways to exploit state institutions to their advantage, such as using loopholes in bankruptcy legislation and bribery of dishonest judges to conduct hostile takeovers of other firms, they received above market-level rewards. Yet as more firms adopted these strategies and invested in the necessary political connections, corporate raids began to result in costly stalemates, encouraging resolution by formal, legal means. Other analysts as well as the Russian business press, have noted these trends (e.g., Bustrin 2003; Volkov 2002, 2004) but have not offered a full analytical account of how this process works. They treat the tendency for resources to equalize among competing groups as almost inexorable, which raises the question of why this process occurs in some countries and not others.

Cooperation and Time-Inconsistency Dilemmas

Even when a firm believes it would be advantageous to bring its business fully in line with the law, the actual process of legalization may be costly and risky, especially if other firms are not yet willing to work within the legal framework. Indeed, as in classic cooperation dilemma situations, even if all firms would be better off in a law-abiding society, this transition may stall, for firms may realize that choosing to constrain their strategies without a guarantee that other firms will do the same may put them at a temporary disadvantage (see, e.g., Hendley 1997, 243). Such situations may result in a prolonged lack of demand for law unless the prospect of future benefits provides sufficient incentive to support legal institutions in the near term.

Firms' strategies are thus powerfully affected by their expectations of the effectiveness of law, law enforcement agencies, and the judicial system in the future. Understanding the factors that affect these expectations is therefore crucial for analyzing businesspeoples' support for legal institutions. As noted above, Russia businesspeople are increasingly aware of how market economies function in the West, and they are also cognizant of the sporadic yet significant efforts by the Russian state to foster a law-abiding society. In interviews, respondents regularly note that restraint is necessary because strategies that provide an advantage today may increase the risk of prosecution or reputational damage at a later date. However, given that firms can only imperfectly predict at what point in the future the risks from unlawful activity will rise, they face the temptation to acquire assets using any means possible prior to the imposition of full-fledged legal constraints. How firms resolve this tradeoff between current benefits and future sanctions is an essential factor contributing to whether the private sector will or will not constitute a source of demand for law.

Chapter 5: Who Wants Law?

Given that firms employ different strategies for acquiring, protecting, and exchanging assets, it naturally follows that the balance of benefits and constraints imposed by formal legal institutions will vary across different types of firms. This chapter utilizes the framework developed in Chapter 3 to analyze the relationship between firms' characteristics and their property defense strategies.

Firm Size

The literature on economic and legal development offers conflicting depictions of the role of small versus larger firms in supporting legal institutions. Many observers have claimed that small businesses are the political foundation of a more transparent

economic and political system. With fewer resources, these types of firms are less able to protect themselves in a chaotic environment, and thus benefit disproportionately from state-provided property protection (Åslund and Johnson 2004; Jackson et al. 2003). Other analysts emphasize, however, that larger firms, having acquired significant assets that they now wish to protect, have played a major role in tax, corporate governance, and judicial reforms (Guriev and Rachinsky 2005; Jones Luong and Weinthal 2004).

I find that both small and large firms face countervailing incentives with respect to the development of legal institutions, but that the dilemma faced by each type of firm differs. While it may be true that small firms disproportionately benefit from state-provided protection, it is also true that small businesses are less likely to pay taxes, less able to afford the court system, less informed about the benefits of legal transactions, and more distrusting of state actors. Moreover, small firms do not face the stimulus of potential FDI, IPOs abroad, or separation of ownership and management.

Large firms, meanwhile, not only have significant assets that they seek to protect, but they also have the resources to bring their businesses in line with laws and regulations, a process that may be prohibitively costly for small firms. However, big firms are also those most likely to have a comparative advantage at manipulating the political or judicial system to undercut competitors, and legal reforms may undercut these advantages. One of the key issues as to whether they are supporters of legal institutions is thus the extent to which they can transfer their comparative advantage in a chaotic environment to a lawful environment by investing in lawyers and legal resources. It follows that a court system that favors powerful actors may thus be a necessary prerequisite for the development of formal institutions.

Market Position

The types of conflicts a firm faces depends significantly on the types and quantity of suppliers, customers/clients, and competitors the firm has. For example, in the case of high-end retail, customers may be powerful figures who can create significant problems for a firm with which they are dissatisfied, such as additional government inspections. Such firms may be forced to develop high-placed connections of their own to stay in business. On the other hand, the number of lawsuits by customers is steadily growing, and firms facing such regular court activity may more quickly come to recognize the importance of legal institutions. Meanwhile, a firm with a handful of longstanding suppliers or clients may be more likely to rely on informal means of resolving disputes; a firm with arms-length contracts with numerous suppliers or clients may make aggressive litigation a strategy to create a reputation that discourages partners from violating contracts. Finally, the nature of competition affects the types of disputes a firm faces in numerous ways. Some respondents, for instance, note that in low competition sectors, high profits make it more feasible for firms to pay taxes and to afford expenses related to bringing their business in line with laws and regulations. Moreover, the most cutthroat sectors may be arenas in which ordered raids and other dirty tactics are widespread.

Types of Assets

A distinction of importance pertains to differences across new economy and old economy firms. Companies that rely primarily on intellectual capital rather than physical products are tough targets for corporate raids or government extortion. Even if a raider, bureaucrat, or mobster can gain control of their assets, he would not have the operational capacity to profit from this acquisition. These firms are usually founded and managed by members of the younger generation of businesspeople, which

also lessens their willingness to use the business practices of the 1990s. In this sense, they are less concerned about physical security threats and attacks on assets. At the same time, creating and trading in intellectual property rights requires a developed legal system. Similarly, the finance sector appears to rely more on the court system and to have been an early lobby for the development of corporate legislation. Financial institutions faced complex transactions and legal questions perhaps earlier on than other sectors. Also, the nature of their products is such that they need asset protection over time in order to collect debts.

Chapter 6: Institutions and Property Rights in Comparative Perspective

This concluding chapter places the evolution of economic disputes and development of the Russian legal framework in comparative, historical, and theoretical perspective. It presents general conclusions about conditions under which private sector actors support the development of legal institutions, which types of private sector actors are most likely to provide a demand for law, and what lessons can be drawn from these findings about state building and the origins of market-supporting institutions.

Several key issues are addressed. First, the literature on the formation of legal institutions in the West may overestimate the state threat to property rights vis-a-vis the private threat. This is because the literature on property rights in Europe focuses on a period in which powerful states had already formed. In such a situation, the business class appears to be a natural proponent of economic rights to protect its interests against a leviathan state. However, the experience of Russia in the 1990s shows that in later developers, the weakness of the state may make expropriation of others' assets a viable source of wealth for powerful private sector actors, leading

them to perceive legal institutions as constraints. Second, the Russian case draws attention to the importance of the types of assets under question. Historical studies focus on a period when assets were largely pre-industrial, consisting of agricultural holdings or financial capital. Industrial assets, on the other hand, fall in value when expropriated by an actor who cannot manage them efficiently. In this sense, the risk of expropriation by private rather than state actors may be greater in later developers. Third, as the example of illegal corporate raiding illustrates, the critical issue in many post-Soviet and developing countries is not so much the *creation* of formal property rights—which inherently involves a battle for recognition on the part of the state—but rather the *enforcement* of these rights. In the case of Russia, de jure property rights emerged rapidly with the adoption of a liberal constitution and mass privatization programs, but to this day businesspeople struggle to maintain control of assets that they nominally own.

Fourth, in the West, basic contract enforcement and property rights protection preceded later forms of regulation, such as state oversight of labor, environmental, and safety issues. In economies such as Russia's, there is often a fine line between enforcement of laws and regulatory burdens, which adds to the dual perception of legal institutions as both beneficial and constraining. Finally, for all developing countries, the interpenetrated nature of the contemporary international economy creates a novel environment that differs greatly from the West's experience of property rights formation. Together, these factors contribute to the complicated and countervailing incentives shaping private sector actors' demand (or lack thereof) for law.