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Building Property Rights: Capitalists and the Demand for Law in Post-Soviet Russia

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Building Property Rights: 
Capitalists and the Demand for Law in Post-Soviet Russia

by

Jordan Luc Gans-Morse

A dissertation submitted in partial satisfaction of the requirements for the degree of Doctor of Philosophy in the Graduate Division of the University of California, Berkeley

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Professor John Zysman, Chair
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Abstract

Building Property Rights:
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by

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Doctor of Philosophy in Political Science

University of California, Berkeley

Professor John Zysman, Chair

The importance of property rights to economic and political development is widely recognized. Yet it remains unclear why institutions for protecting property rights often fail to emerge. Many scholars focus on leaders’ incentives and assume that if institutions are “supplied,” then firms will automatically use them. By contrast, this study emphasizes that firms often circumvent or subvert newly created institutions. Consequently, theories of property rights formation should not focus exclusively on whether or not leaders create institutions. They must also explain the conditions under which firms actually use formal institutions for protection.

This study analyzes firms’ strategies for protecting property rights in Russia and identifies conditions under which firms rely on state institutions. Observers of Russia frequently focus narrowly on high-profile property rights disputes and mistakenly conclude that the lawlessness of the 1990s persists. However, my original survey of Russian enterprises and in-depth interviews with firms, lawyers, and private security agencies reveal a remarkable shift in firms’ strategies over time: Whereas Russian firms in the 1990s used illegal coercion — such as mafia rackets — to protect property, today they increasingly utilize law and formal institutions.

To examine this shift in firms’ strategies, I develop an analytical framework based on evolutionary game theory. The framework draws attention to several key characteristics of institutional development: (1) The expected payoffs to firms’ strategies for protecting property depend on the interplay of direct effects (i.e., exogenous factors that determine the benefits and costs of a given strategy) and interactive effects (i.e., the extent to which other firms in an economy use a given strategy). (2) Over time, more effective strategies become predominant, due to mechanisms such as natural selection or adaptive learning. (3) A tipping point
exists, at which society begins to break from a vicious cycle to a virtuous cycle. Relatively small changes can therefore initiate self-reinforcing cycles with large effects.

Based on this analytical framework, the study investigates the sources of change in firms’ strategies. Over the past decade, an *incentive transformation* has occurred. Firms now recognize that law is a more effective tool for protecting property than alternatives, such as private security agencies or informal connections with government officials. Three types of factors have shifted the benefits and constraints of illegal versus legal strategies in favor of law: (1) organizational changes within firms, such as the evolution of firm ownership structures; (2) changes in other institutional spheres, including the development of the tax administration and banking sector; and (3) changes from outside the domestic political and economic system, including the inflow of foreign investment.

Incentive structures also explain variation across firms’ strategies for protecting property. The nature of threats and available resources shape the relative benefits and constraints of using illegal versus legal strategies. Analysis of these two factors predicts the *types* of firms most likely to use legal strategies: (1) medium-sized firms rather than small or large firms; (2) firms that produce physical products rather than services; (3) firms that operate in large-scale rather than exclusively local markets; and (4) firms that lack informal connections to government officials.

This study’s conclusion explores pathways to the rule of law in transition and developing countries, with specific reference to Russia. Whether the rule of law will take root in Russia depends on the outcome of two conflicting tendencies: (1) increasing demand for law by firms; and (2) decreasing supply of law by predatory state officials.
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Chapter 1

Demand for Law

Capitalism emerged quickly in post-Soviet Russia — at least on paper. On January 2, 1992, the Russian government implemented a presidential decree to abolish price controls on nearly all goods and services. Soon after, the government declared the right of firms and citizens to buy, sell, and trade as they pleased, which for nearly 70 years of Soviet rule had been a crime. No longer would administrative planning determine the allocation of resources, but rather market forces and the intersection of supply and demand. The year 1992 also marked the beginning of the largest transfer of assets in human history. In a span of less than four years, the Russian state sold approximately 120,000 enterprises to private owners (Blasi et al. 1997, 189). After decades of the Soviet command economy, with its strict prohibitions on nearly all forms of private ownership, private property rights were created practically overnight. In 1993, they were enshrined in Article 35 of the new Russian Constitution.

The challenges facing Russia’s new capitalists, however, were just beginning. By 1995, the foundations of a market economy — privately owned means of production and free trade coordinated by market prices — were in place. But in contrast to the West, where court systems, regulatory bodies, and specialized law enforcement agencies emerged organically as market economies evolved, capitalist systems in the post-Soviet region were created prior to the institutions vital for a smoothly functioning market economy. Russia’s capitalists soon realized that without the ability to enforce property rights, their shareholder certificates, corporate documents, and contracts were little more than words on parchment.

Many analysts would later offer scathing critiques of Russian reformers’ inattention to the importance of institution building (e.g., Klein and Pomer 2001; Stiglitz 1999). Yet the reality was that the reformers were well aware of the importance of institutions, and they devoted, given the extraordinarily difficult circumstances, reasonable attention to developing courts, the tax administration, and key regulatory bodies (Treisman 2010, 205-206, 220-221). The fact was that they faced a Herculean task: to build new institutions from scratch or to
transform institutions built under socialism into tools for supporting a market economy.

A major impediment to the formation of effective institutions proved to be not the inattention of government reformers, but the hesitancy of firms to use law. Reformers and observers had assumed that once state assets were placed in private hands, Russia’s new capitalists would actively lobby for the development of institutions that protect property rights and then put those institutions to good use (Boycko and Shleifer 1995). After all, effective institutions ostensibly raise the value of assets, ensuring that contracts are binding and that property rights will not be expropriated. Yet throughout the 1990s, Russia’s firms routinely ignored formal institutions, relying not on law but on violence and coercion — the most extreme form of which was criminal protection rackets — to accumulate assets, protect claims to property, and enforce contracts.

By the end of the 1990s, observers had concluded that a central problem facing Russia was a deficit in the “demand for law,” and grim predictions of anarchy, economic collapse, or a criminalized society followed (Black et al. 2002; Polishchuk and Savvateev 2004; Stiglitz and Hoff 2004). These grim depictions proved unfounded. As the first post-communist decade came to a close, firms increasingly substituted lawyers for mafia enforcers and replaced violence with lawsuits. This is not to say that a fully law-based society emerged in Russia. As discussed below, recent years have witnessed a marked deterioration in state actors’ willingness to abide by laws and provide impartial adjudication in disputes among firms. Yet even amidst the backsliding on the part of government officials, firms continue to increasingly rely on law to acquire and protect assets.

As an empirical phenomenon, the strategies firms use to enforce property rights have evolved dramatically over the last two decades. The scope of change is remarkable and deserves attention. Unfortunately, this evolution has been all but ignored in the West.1 Journalists and many scholars instead have focused myopically on a handful of high-profile property rights disputes, such as the jailing of the Russian business tycoon Mikhail Khodorkovsky and the attempt by corporate raiders with ties to government officials to expropriate the assets of William Browder, previously the largest foreign portfolio investor in Russia.

From the perspective of comparative politics, there are also important theoretical reasons to examine firms’ strategies for protecting property and enforcing contracts. The evolution of Russian firms’ strategies offers insights into the formation of the rule of law, the process of state building, and the foundations of modern market economies. As the case of Russia demonstrates, rulers’ state-building efforts amount to little if societal actors circumvent or subvert formal institutions. For formal institutions to transcend mere words on paper, the official rules of the game must converge with the de facto rules governing relations among firms, individuals, and state actors.

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1 The prominent exception is the work of Kathryn Hendley. See, for example, Hendley et al. (2001b) and Hendley (2006).
CHAPTER 1. DEMAND FOR LAW

What accounts for such convergence? Through analysis of the shift in Russian firms’ strategies for acquiring and protecting assets, this study examines the factors that stimulate private sector actors’ use of law and formal institutions. I argue that an incentive transformation has occurred: Firms have recognized that law is a more effective tool for protecting property than the alternatives, such as private security agencies or illicit connections with government officials. Three types of factors have shifted the benefits and constraints of illegal versus legal strategies in favor of law: (1) changes within firms, such as evolution of firms’ ownership structures; (2) changes in institutional spheres that complement the judicial system, such as the tax administration or banking system; and (3) changes from outside the domestic economic and political system, such as foreign investment.

This study’s focus on the incentives faced by firms stands in contrast to dominant trends in analyses of property rights, which primarily focus on rulers. While existing studies have provided valuable contributions to the understanding of institutional origins, analysis of the factors that stimulate firms’ use of law can offer fresh insights into the formation of institutions that protect property rights.

1.1 Institutional Origins and 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). When and why states “supply” formal institutions is undoubtedly an important question, but equally pressing is the issue of when and why private sector actors “demand” the development of and come to rely on such institutions (Hendley 1997, 1999, 2001; Pistor 1996, 1999; Yakovlev et al. 2004). If firms face incentives to circumvent or subvert formal institutions, then formal institutions will remain disengaged from the informal rules governing economic transactions.

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

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2 There is also a sizeable 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).
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.

As noted above, there is ample logic to support the assumption that private sector actors seek the development of institutions protecting property and enforcing contracts. Capitalists, the holders of productive assets, 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. 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.
1.2 Demand for Law in Russia

At the outset of the 1990s, Russia’s economic reformers posited a theory of institution building explicitly based on demand for law. As noted above, 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, firms relied extensively on private coercion — such as criminal protection rackets and private security agencies — to adjudicate and resolve economic conflicts (Skoblikov 1997; Volkov 2002). Meanwhile, managers and owners of firms, unaccustomed to resolving disputes through recourse to law, shied away from the formal legal system (Hendley 1997). 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; Goldman 2003; Hellman 1998).

In recent years, however, Russia’s rising business class has increasingly lobbied for the development of formal institutions that protect property rights. Business associations and powerful business magnates played a significant role as Russia amended or developed anew a wide range 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). This shift reinvigorated debates about whether privatization had created a “rule-of-law lobby,” albeit in delayed fashion.\(^3\)

Yet lobbying for institutional development is only one aspect of institutional demand. Indeed, as Hendley (1997, 239) noted in her seminal article on demand for law in Russia, “From a practical and systemic point of view, routine reliance on law by Russian economic actors who are structuring transactions and resolving disputes is more important than their participation in the legislative process.” Alongside lobbying efforts, significant changes in firms’ strategies for acquiring and protecting property occurred. For example, the number of 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.

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. Consequently, a prerequisite to a demand-side theory of property rights is the identification of the conditions under which firms rely on and support the de-

\(^3\) See, for example, Boone and Rodionov (2002), Treisman (2002), and Zhuravskaya (2007); for skeptics, see Barnes (2003) and Schwartz (2006, ch. 11).
CHAPTER 1. DEMAND FOR LAW

Development of formal state institutions. The dramatic transformation of the Russian business environment over the last two decades offers a unique opportunity to examine both how conditions have changed over time and how evolving conditions affect firms of different types. Moreover, whereas studies of property rights have traditionally exhibited an 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.

1.3 Property Security Strategies

Demand for law is a broad and multifaceted concept. In line with Hendley’s (1997) initial emphasis on the use of law, this study focuses concretely on firms’ strategies for acquiring assets, protecting property, and enforcing contracts. 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 security.

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 security 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, 7; also see Cole and Grossman 2002). This shift 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

---

4 See, for example, the debates in East European Constitutional Review 8 (4), 1999.
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 of the modern state are vital prerequisites for distinguishing between the legal and illegal use of coercion, which is in turn 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.

Along with the distinction between illegal and legal coercion, a second distinction — the distinction between strategies that rely on state actors and strategies that rely on private actors — is critical to understanding firms’ tools for property security. Even 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 illustrates that even in polities with a highly developed state apparatus, firms continue to utilize strategies that rely on private actors, as depicted in Figure 1.1. This study examines four categories
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of property security strategies:

**Private Force:** Strategies of private force 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 security in the early 1990s.

**Corrupt Force:** Strategies of corrupt force rely on state actors who wield violence without regard to the distinction between legitimate and illegitimate coercion. 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. These strategies are corrupt because they use state resources for private gain. They are a form of force because they use coercion without reference to legality and outside of the regulation of formal rules.

**Delegated Law:** Strategies of delegated law rely on private actors who use non-violent means to enforce property rights. In even the most developed economies, non-state actors play a significant role in property rights enforcement, but unlike the use of private force, these strategies complement state institutions. 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. Similarly, business associations offer a form of private property rights enforcement by sorting out disputes among their members. But the effectiveness of organized interests such as business associations results from the state delegating authority so that private institutions can supplement state institutions.

**Institutionalized Law:** Strategies of institutionalized law rely on state actors who resort to violence and coercion only in accordance with formal rules. Such strategies entail the use of the formal institutions of the state — courts, regulatory officials, and law enforcement agencies — to enforce property rights.

The classification of property security strategies presenting in Figure 1.1 naturally refers to ideal types. In reality, the boundaries between illegal and legal coercion may be blurry, particularly in transition periods when laws themselves are changing. This may be especially true in the case of corrupt force, where cautious government officials may violate the spirit of the law while treading carefully to uphold the letter of the law. In other instances, evolution over time may transform the nature of a given strategy. In the early-to-mid 1990s, for example, many private security agencies played a role nearly indistinguishable from criminal protection rackets, putting them squarely in the category of private force, as in Figure 1.1. Yet over time, as discussed in Chapter 2, private security agencies increasingly came to abide
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by laws and to operate within the framework of government regulations, fulfilling functions best described as a strategy of delegated law.

While no typology perfectly encapsulates the messiness of the real world, the classification of property security strategies presented here offers improvements over the dichotomies that appear frequently in other studies of institutional development: illegal vs. legal, informal vs. formal, and private vs. state. While these contrasting pairs of traits capture important elements of the transformation from an unlawful to a rule-based 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, both mafia rackets and business associations are private actors, but it is misleading to include them in a single category; 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 property claims to enforcing property rights. As shorthand, I will frequently refer to a shift from force to law. 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; however, it has changed forms. Firms have almost completely abandoned private force as a viable strategy, even as the use of corrupt force persists.

1.4 Norms, State Coercion, and Self-Interest

How can we account for the shift in firms’ property security strategies? Whereas traditional studies of property rights focus on the establishment of new institutions, a study of property security strategies requires a fundamentally different approach. Understanding the politics behind the creation of new rules of the game has little to do with understanding the politics of constituents’ behavior after formal rules are in place. Rather than a bargaining or lobbying process between a handful of powerful, organized actors, the focus shifts to the interaction among numerous smaller, weaker actors — and to whether they use, circumvent, or subvert the formal institutions put in place in the realm of high politics.

Similar to studies about why people comply with laws, the study of property security strate-
gies can be approached from a normative or an instrumental perspective. The normative perspective on legal compliance “is concerned with the influence of what people regard as just and moral as opposed to what is in their self-interest.” People obey the law voluntarily, not out of fear of punishment. They either believe they have a moral commitment to obey laws, or they believe in the legitimacy of legal authorities’ “right to dictate behavior” (Tyler 2006, 3-4). By contrast, according to the instrumental perspective on legal compliance, “people are viewed as shaping their behavior to respond to changes in the tangible, immediate incentives and penalties associated with following the law — to judgments about the personal gains and losses resulting from different kinds of behavior” (Tyler 2006, 3).

The normative and instrumental perspectives on compliance are not mutually exclusive, and in nearly all societies they each play at least some role. But there is scant evidence that the transformation of Russian firms’ property security strategies can be attributed to a normative shift. Throughout a year of fieldwork in Russia, including 90 in-depth interviews with firms, lawyers, and private security agencies, not once did a respondent raise the issue of morality in discussions about firms’ increased reliance on law. To the contrary, five respondents cited — without my prompting — the same Russian proverb, “Law is like a carriage’s steering shaft: You can turn it whichever way you please,” an explicit reference to the instrumental manipulation of law in the Russian context. An America lawyer with more than 15 years of experience in the post-Soviet countries was even more blunt on this point: “Russians view law as a tool. There is no emotional investment as in America. The evolution of the courts is a pure evolution of functionality, of finding new ways to use the [available] tools” (author interview, 5 March 2009, 030509-L4).

Nor is there evidence of a sizeable shift in the legitimacy of the legal system. According to the 1999 World Bank-EBRD Business Environment and Enterprise Performance Survey (BEEPS), only 18 percent of Russian firm managers reported that they would consider the court system “fair and impartial” in resolving business disputes. In the 2002 BEEPS survey, the corresponding figure was 14 percent; in 2005, 21 percent. Similarly, the 1999 BEEPS survey revealed that a mere 15 percent of firm managers considered the court system “honest and uncorrupt” in resolving business disputes. In the 2002 BEEPS survey, the corresponding figure was 14 percent; in 2005, 20 percent. These modest increases can hardly account for the dramatic transformation in Russian firms’ property security strategies that are analyzed in Chapter 2.

Within the instrumental perspective, however, further distinctions of importance must be made. When concerned with criminal law, this perspective emphasizes the threat of state coercion and citizens’ self-interested desire to avoid sanctions (Becker 1968). Margaret Levi’s

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5 *Zakon chto dyshlo, kuda povernyesh — tuda i vyshlo.*
(1989, 50) classic analysis of tax compliance similarly addresses the role of state coercion in compelling constituents to comply. In the case of Russia, it is indeed tempting to attribute any shift in firms’ behavior to Vladimir Putin’s rise to power and the subsequent restoration of state capacity. Certainly, there is some truth to this interpretation.

The Russian state in the 1990s was in disarray to an extraordinary extent. Tax revenues to the federal government dropped from just under 18 percent of GDP in 1992 to just over 10 percent of GDP at their nadir in 1998, even as GDP during this period collapsed amidst an economic decline akin to America’s Great Depression. Starved for resources, formal institutions struggled to operate effectively. Firms, criminal rackets, and private security agencies challenged the state’s monopoly on coercion and violence with impunity. Government officials often freelanced, using state resources at their disposal to run private security operations that substituted for official law enforcement and adjudicatory institutions. Multiple centers of power — the federal government, regional leaders, and powerful business tycoons frequently referred to as “oligarchs” — battled for control of the nation’s political levers. These battles tore apart the state to such an extent that some observers questioned whether at a geopolitical level, we would soon witness a “world without Russia” (Graham 1999).

Upon coming to power, first as Prime Minister in 1999 and then as President in 2000, Putin placed the recentralization and re-ascendancy of the Russian state as his foremost goal. His selective crackdown on oligarchs and deft political outmaneuvering of regional leaders reestablished the supremacy of the federal government. Aided by tax reforms, robust economic growth, and the skyrocketing price of oil, state revenues climbed steadily. Courts, regulatory agencies, and law enforcement bodies began to reassert their role in defining and enforcing the rules governing Russia’s economy, albeit with varying levels of effectiveness.

These changes undeniably affected firms’ property security strategies. The probability that strategies based on force would result in sanctions increased. Meanwhile, the increased effectiveness of law enforcement and judicial institutions made reliance on law a more viable option. Yet to attribute the shift in Russian firms’ property security strategies primarily to the state’s increased monitoring and enforcement capacities would be to overlook significant trends and several issues of considerable importance. First, scholars since Weber (1968) have recognized that coercion is never sufficient in and of itself to lead to widespread compliance. Overreliance on coercion is simply too costly to be fully effective. For widespread compliance to occur, constituents must at least partially comply voluntarily, be it because of their normative convictions or because they believe that doing so promotes their interests (Levi 1989).

Second, the transformation in Russian firms’ property security strategies involves something more than improved legal compliance. It also entails an increase in firms’ active reliance on formal institutions as a resource for protecting assets and resolving disputes. Firms’ use of private or corrupt force clearly violates laws and may undermine or subvert state institutions. But firms may also simply circumvent and avoid formal institutions, refusing to use courts
or turn to law enforcement even in times of need. In such cases, no law is violated, yet the transformation in property security strategies required to overcome the divergence between *de facto* practices and the formal rules of the game does not take place. In other words, the switch from force to law involves a transformation similar to what Hendley (1996, 3) describes as a change from “coercive” to “reciprocal” law, meaning that citizens come to recognize law as a tool for “remedying wrongs and advancing interests.”

The focus of this study is thus on the shifting incentive structures that make it advantageous for firms to use law instead of force, rather than on the state’s increased coercive power. My findings, based on in-depth interviews and survey evidence, indicate that while improvements in state capacity have played some role in transforming property security strategies, there are other factors of equal or greater importance. Some of these factors have resulted from evolution within the Russian economy. In Chapter 4, for example, I examine changes in firms’ ownership structures that have raised the relative costs of using property security strategies that rely on force. Other factors have been imposed from outside of Russia. Firms’ efforts to attract international investment have been a major source of the incentive transformation that has taken place. Yet another set of factors pertains to institutional change that is only indirectly related to legal institutions. Development of an effective tax administration and banking sector, for instance, has lowered barriers to the use of law. Finally, as discussed in Chapter 3, the benefits’ to using law depend significantly on the extent to which other firms use law instead of force. Law and legal institutions function only when a critical mass of actors believe they function and act accordingly; when this happens, law provides predictability and order. Russian firms’ recognition that other firms are increasingly using law has had a powerful and independent effect on property security strategies.

### 1.5 Demand for Law and State Capacity

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.

When private sector actors use property security 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 et al. 1985; Geddes 1994; Zysman 1983). 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. 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, as noted above, laws and legal institutions matter only to the extent that private sector actors believe that they matter for other private sector actors. 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. The concluding chapter of this study examines the relationship between firm strategies and state building in greater detail.

1.6 Demand for Law vs. The Rule of Law

Demand for law 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. 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). 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 power, 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: State vs. Private Threats to Property Rights

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-to-mid 1990s. Private threats with 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, was heading in this direction. Meanwhile, reprieve from 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.

It is, therefore, essential to recognize the scope of this study. The claim that a significant transformation in property security strategies from force to law has taken place is not intended to indicate that the rule of law has broadly taken root in Russia. Demand for law, no matter how important, is only one component of the rule of law. However, the focus here on the “demand side” of institutional development is justified. As noted at the outset, prominent studies of property rights have devoted a disproportionate amount of attention to rulers’ incentive structures — the “supply side” of institutional formation (e.g., Acemoglu and Robinson 2006; North 1981; Olson 1993). Much less is known, however, about the factors that facilitate demand. Understanding these factors is therefore a necessary step that
must be taken before a comprehensive theory that merges both demand- and supply-side issues can be established.

It should also be noted that 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.

1.7 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, 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

\[7\] Details about the sample of respondents are presented in Appendix 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 the summer of 2010, I conducted an original survey of 300 Russian firms from eight cities: Moscow, St. Petersburg, Nizhniy Novgorod, Ekaterinburg, 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.

1.8 Chapter Overview

The remainder of this chapter provides an overview of the argument via an outline of the study’s chapters.

Chapter 2: From Force to Law

Chapter 2 examines the evolution of firms’ property security 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. Evidence from in-depth interviews and my survey of Russian firms indicates that a transformation from protecting property claims to enforcing property rights has occurred. To the extent that force rather than law continues to play a role, corrupt force has replaced private force. Four notable trends are:

The decline of private force: In the early to mid-1990s, Russian firms relied extensively on criminal protection rackets and private security agencies. Today, criminal protection rackets

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8 Details about the survey are presented in Appendix B.
have all but disappeared. Meanwhile, the role of private security agencies has been transformed. Just like their Western counterparts, private security firms in contemporary Russia primarily provide basic physical protection of buildings, cargo, and business executives.

_The persistence of corrupt force:_ As Russian firms turned away from private force in the mid-to-late 1990s, they began to utilize property security strategies that relied on the corrupt appropriation of state resources, such as the protection rackets offered by law enforcement officials. Alongside the legitimate use of formal state institutions, property security strategies involving corrupt force persist to the present day.

_The development of delegated law:_ In the 1990s, firms rarely used property security strategies that rely on private organizations, such as business associations or private arbitration. While less popular than in developed countries, the use of private arbitration in Russia is growing and many firms have begun to rely on business associations as a source of legal advice and protection from property rights abuses, particularly by government officials.

_The rise of 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 Russia’s commercial courts rose by over 300 percent.

In summary, while the use of force has not entirely disappeared, firms’ property security strategies have evolved toward law considerably since the 1990s.

**Chapter 3: Property Security Strategies from the Firm’s Perspective**

Chapter 3 develops an analytical framework for understanding how firms select property security strategies. It combines formal modeling with insights drawn from in-depth interviews of Russian businesspeople, lawyers, and private security firms. Whereas analysts often focus exclusively on the benefits society derives from legal institutions, my research reveals the countervailing incentives that these 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 firm’s security expenses but also makes it riskier to bribe law enforcement officials to turn a blind eye when acquiring a competitor’s 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 an individual derives from also complying.

**Chapter 4: Transforming Incentives and the 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 my survey of firms, the focus is on the evolution in property security strategies over time. Three sets of factors are examined: (1) the evolution of firms’ ownership structures; (2) the development of the tax administration and banking system; and (3) the inflow of foreign investment.

*Evolution of Firms’ Ownership Structures*

The transformation of ownership structures played a particularly significant role in firms’ shift from strategies based on force to strategies based on law. Once they consolidated their stakes in privatized firms, owners began to focus on longer-term investments. This longer-term perspective placed a higher value on stability and reputation, which raised the costs of using property security strategies based on force and corruption. Meanwhile, the expansion of modern shopping centers, business centers, and retail chains provided firms with new forms of security. These transformations of the workplace and shopping place reduced the relative value of private force and informal government connections, while also placing constraints on lower-level managers’ ability to resort to coercion and corruption.

*Development of the Tax Administration and Banking System*

Tax reform is essential for the development of formal legal institutions. As long as firms are unwilling or unable to pay taxes, they hesitate to rely on law enforcement and the court system for fear that doing so will lead to scrutiny of their tax violations. They are thus forced to rely on private force. The development of the banking system is similarly crucial. Since the early 2000s, there has been a massive shift from transactions done in cash to transactions conducted through banks. Access to cash 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 replace strategies based on force with strategies based on law.

*Foreign Investment*

In contrast to the development of legal institutions in the West, institutional development in
post-Soviet economies is occurring in a globalized environment. Multinational corporations, international financial institutions, and cross-national financial flows have had a significant impact on property security strategies. A major motivation for conducting lawful business is the prospect of carrying out an initial public offering (IPO) on a foreign stock market or attracting foreign direct investment (FDI). Firms realize that a reputation as a law-abiding company can increase their value on international capital markets, while a reputation for the use of illegal strategies can potentially scare away investors.

Chapter 5: Who Uses Law?

Different types of firms employ distinct strategies for acquiring, protecting, and exchanging assets. Accordingly, their incentives to use force versus law vary. This chapter utilizes the framework developed in Chapter 3 to analyze the relationship between firms’ characteristics and their property security strategies. The development of law and formal legal institutions imposes both benefits and constraints on enterprises. This is true for all firms, but the balance of these benefits and constraints differs according to enterprises’ characteristics. Two factors are of particular importance: the types of threats firms face and the resources at firms’ disposal. This chapter examines differences across firms, with a focus on three key issues: (1) firm size, sector, and market type; (2) relational assets; and (3) choke points and legal foundations.

Firm Size, Sector, and Market Type

Firms of different sizes, from different sectors, and operating in different types of markets face distinct threats and have access to distinct resources for asset protection. Although existing research predicts that demand for law should emerge among the small business sector, my findings reveal a curvilinear relationship between firm size and property security strategies: Medium-sized firms appear more likely to rely on law than either small or large firms. Meanwhile, firms that deal in the production or distribution of physical products — as opposed to the provision of services — face more direct and concrete threats to their assets, and therefore place greater value on a widespread shift from force to law. Finally, firms that operate in local as opposed to national markets are more likely to rely on informal connections and corruption.

Relational Assets

The types of people and organizations with whom a firm regularly interacts — “relational assets” — contribute to variation in firms’ property security strategies. After all, the resources required to use force, such as informal connections with government officials, are not equally available to all firms. Informal services are for sale, but not on an open market. Because of the corrupt nature of the transaction, the trust that evolves out of long-standing and personal relationships is particularly important. Firms that have regular contact with
people who can provide such services are more likely to use them. Relational assets develop in a variety of ways: sales to clients, purchases from suppliers, or regular interaction with government regulators. Consequently, a firm’s market position vis-à-vis distinct types of customers, suppliers, and government officials can affect its property security strategies.

**Choke Points and Legal Foundations**

There are foundational moments in the life cycle of a firm and foundational points within a firm’s supply chain that affect all subsequent threats and resources. If a certain permit is nearly impossible to legally obtain, then a firm that relies on such a permit may struggle to operate legally and be forced to avoid formal institutions for fear of scrutiny. If imports cannot be conducted without legal violations, then the range of strategies for addressing conflicts during downstream transactions may be more limited. Identifying such choke points is thus essential for understanding variation in property security strategies across firms.

**Chapter 6: From Demand for Law to the Rule of Law**

This concluding chapter places the evolution of property security strategies and private sector demand for law in broader theoretical perspective. It presents general conclusions about pathways to the rule of law in transition and developing countries.

Several key issues are addressed. First, studies that focus on historical, cultural, or religious foundations for the rule of law are of little use outside of the West. History cannot be rewritten and culture cannot be easily transformed. Yet the shift in Russian firms’ property security strategies indicates that by focusing on incentive transformations, rather than norms and beliefs, relatively rapid changes in the willingness of actors to contribute to a rule-bound society can be induced. Second, the critical issue in many post-Soviet and developing countries is not so much the creation of formal property rights 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. Third, 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, which was largely a domestic phenomenon. Finally, while secure property rights are but one aspect of the rule of law, they may serve as a foundation for further rule of law development, led in large part by an emerging business class. It is the business sector that possesses both the access to resources and the direct material incentives to demand law.

The chapter concludes with consideration of the prospects for the rule of law in Russia. Whether the rule of law will take root depends on the outcome of two conflicting tendencies. On the one hand, demand for law on the part of firms is increasing. On the other, state
officials are becoming increasingly predatory. Which tendency will prove more enduring remains to be seen.
Chapter 2

From Force to Law

Post-Soviet Russia offers a unique opportunity to explore the factors that underlie private sector demand for legal institutions. Over the last two decades, a dramatic transformation has occurred. Russian firms largely have switched from force to law as their preferred tool for securing assets and resolving disputes. In the terminology of the typology introduced in the preceding chapter, a fundamental shift has occurred in firms’ property security strategies from protecting property claims to enforcing property rights. In order to examine the factors driving this transformation, it is first necessary to explore the nature of the changes that have occurred. The current chapter provides an overview of this evolution.

The collapse of the Soviet Union and the ensuing chaos of the early 1990s produced extreme lawlessness. In rapid fashion a society with massive industrial assets plunged into an institutional vacuum. Courts, law enforcement bodies, and state regulatory agencies capable of enforcing the rules of the game for a modern market economy had to be created from scratch or rebuilt from the remnants of socialist institutions. In the absence of effective state institutions, firms turned to alternative forms of property security. Mafia rackets and private security agencies provided physical protection, collected debts, and adjudicated disputes among firms. When large sums of money were at stake, contract killings became a prominent means of acquiring or protecting assets. In short, outright force or the threat of physical coercion became common tools for protecting property and ensuring adherence to business agreements. Meanwhile, Russian firms during this period largely circumvented formal legal institutions. Accustomed to the Soviet system in which political connections and informal negotiations maintained inter-enterprise transactions, the formal and impersonal nature of litigation was alien to many firm managers and owners. Consequently, law played a minimal role in struggles over assets and in resolving business disputes.

Today, 20 years after the fall of the Iron Curtain, the logic of property security in the Russian business world has changed dramatically: Law has to a significant extent replaced force. To
be sure, high profile cases of property rights abuses continue to dominate many journalistic accounts of Russia, as well as some policy and academic studies (e.g., Edwards 2009; Hoff and Stiglitz 2008). But this narrow focus is misleading, as it offers a skewed and unrepresentative portrayal of modern-day Russian business practices. In part, this is because such accounts often concentrate primarily on a handful of tycoons and the extent to which these “oligarchs,” as they are frequently called, hinder or promote the development of legal institutions (e.g., Boone and Rodionov 2002; Guriev and Rachinsky 2005; Jones Luong and Weinthal 2004). By contrast, this chapter focuses on ordinary Russian firms’ everyday practices as they seek to prevent and resolve contract disputes and battles over assets.

Drawing on in-depth interviews with 90 Russian businesspeople, lawyers, and private security agencies, as well an original survey of 301 Russian firms from eight cities, this chapter analyzes four substantial shifts: (1) the decline of private force; (2) the persistence of corrupt force; (3) the development of delegated law; and (4) the rise of institutionalized law.

**The decline of private force:** Studies conducted in the early to mid-1990s by Russian governmental 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.

**The persistence of corrupt force:** As Russian firms turned away from private force in the mid-to-late 1990s, they began to utilize property security strategies that relied on the corrupt appropriation of state resources. Foremost among these were 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” (zakaznoi 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 security strategies involving corrupt force persist to the present day, intermingling with the legitimate use of formal state institutions.

**The development of delegated law:** In the 1990s, firms rarely used property rights enforcement strategies that relied on private organizations, such as business associations or private arbitration. Compared to developed economies, the enforcement of property rights by pri-

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1 For details regarding the interviews and survey, see Appendices A and B at the conclusion of the study.
vate actors in Russia remains underutilized; however, 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.

The rise of institutionalized law: In the early to mid-1990s, few firms relied on lawyers and
courts. By contrast, caseload data, surveys, and interviews offer evidence that law plays
a major role in contemporary Russian business. From 1994 through 2009, the number of
cases decided in Russia’s 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 lawfully, rather than to growing conflict among firms.

Naturally, research on sensitive topics, such as illegal activities, entails challenges. Firms that
are most likely to engage in strategies outside of the law may be less likely to participate
in the research. Among participants, there may be hesitancy to provide truthful answers.
While these concerns cannot be ignored, they also should not be over-exaggerated. First,
many types of unlawful behavior in countries such as Russia are open secrets that are more
culturally appropriate to discuss than imagined by outside researchers. This observation is
supported by other analysts. For example, Daniel Kaufmann, formerly one of the World
Bank’s foremost experts on corruption and the rule of law, has concluded that “With ap-
propriate survey instruments and interviewing techniques, respondents are willing to discuss
corruption with remarkable candor” (Kaufmann et al. 2001). Second, the magnitude of the
shift in strategies examined in this chapter is overwhelming. As many as half of all firms
reported contact with criminal protection rackets in surveys conducted in the 1990s, while
fewer than 10 percent report contact in recent surveys. Unless firms have become dramati-
cally less inclined to tell the truth over time, a genuine transformation has occurred. Thus,
even if surveys provide rough estimates of difficult-to-measure illegal activities that in some
cases may be downwardly biased, large changes over time are informative indicators.

Multiple steps nevertheless were taken to ameliorate concerns about the sensitive nature of
the research. Following techniques used in World Bank surveys on corruption, interview and
survey questions were phrased in an indirect manner designed to elicit information without
requiring respondents to incriminate themselves, such as “Many people have told us that firms like yours pay protection payments to local rackets. Can you estimate how frequently a typical firm in your line of business makes such protection payments?” Additionally, the
combination of multiple methodological approaches — in-depth interviews, survey research,
and the collection of objective data such as court caseload statistics — allows for triangu-
lation. The fact that multiple methods lead to similar conclusions indicates the validity
of the findings. Moreover, these approaches complement each other. Whereas larger scale
surveys offer insights into the generalizability of the findings, in-depth interviewing allows
respondents to answer sensitive questions using non-incriminating gestures and the use of “codewords” (e.g., referring to bribes as “fines” while using hand gestures to put the word in quotation marks).

The available evidence thus indicates that a shift from force to law is both significant and extensive. One important caveat is nonetheless in order. The evolution in property security strategies has taken place unevenly across firms of different size and type. This issue is examined at length in Chapter 5.

2.1 Decline of Private Force

In the wake of the Soviet Union’s collapse, private force came to play a significant role in Russian firms’ property security strategies. Businesspeople frequently settled disputes through threats of violence, eradicated competitors through contract killings, and relied on thugs or private security agencies to enforce contracts. Whereas in most countries organized crime is limited to illegal sectors such as prostitution, drugs, arms trafficking, fraud, and money laundering, many firms in early post-Soviet Russia relied on criminal protection rackets to provide fundamental protective and adjudicative functions usually fulfilled by modern states. Yet contrary to popular belief, this era of thuggery peaked before the mid-1990s and then faded in most of Russia’s regions by the end of the first post-communist decade. Organized crime remains a significant problem, but it is no longer part and parcel of everyday business transactions in Russia. It is instead limited to those illegal sectors “where it belongs,” in the words of Elena Panfilova, the director of the anti-corruption organization Transparency International’s Moscow office (author interview, 12 February 2009).

Another prominent property security strategy in the 1990s that relied on private force was firms’ use of private security agencies. Staffed with former members of law enforcement and national security organs, these private security agencies gradually replaced criminal groups in providing protection, adjudication, and enforcement services. After the end of the wild 1990s, however, demand for the services of private security agencies also evolved. Businesspeople came to rely on security agencies primarily for the same types of security services such agencies provide in Western countries: provision of physical protection for buildings, lots, and transport. Along with these developments, criminal and physical threats gave way to a broader definition of “economic security” (ekonomicheskaya bezopasnost) encompassing information security and intelligence gathering, managing relations with government officials, and protecting owners from crimes by employees.

Russian firms’ reliance on organized crime had its roots in the criminal subculture that emerged out of the Soviet labor camps. From the Brezhnev period onward, informal entrepreneurs filled the economic niches created by the inefficiencies of the Soviet command
economy. Given that private economic activity was illegal, these early kommersanty required sources of protection and arbitration outside of the state. The vory v zakony, or “thieves professing the code,” who emerged from the labor camps were well-suited for this role. They had developed a complex informal hierarchy for governance of the underworld and honed skills, such as counterfeiting official documents, essential for moving goods in the Soviet period.\(^2\)

The initial legalization of private economic activity with the 1987 Law on Individual Labor Activity and the 1988 Law on Cooperatives created new fodder for criminal rackets. The rapid emergence of small-time entrepreneurs and open-air markets led to ideal conditions for extortion. In addition to the criminals who earned their underworld laurels in the Soviet penal system, racketeers and thugs, known as bandity, emerged from three sources with a comparative advantage in the application of violence: groups of sportsmen, especially boxers, wrestlers, and martial arts specialists; criminal gangs based on ethnic networks from the Northern Caucuses; and veterans returning from the war in Afghanistan.

Although bandity initially made a living through extortion of kiosks at open-air markets, their relations with Russia’s emerging capitalists rapidly evolved. As markets became crowded with competing criminal protection rackets, gangs began to offer protection from other bandity in exchange for a percentage of entrepreneurs’ profits, a service known as providing a “roof” (krysha). Soon markets were divided into spheres of influence, with sellers displaying insignia to warn would-be extorters that they were under the protection of a given criminal leader. The privatization of state-owned enterprises repeated this process on a larger scale. Suddenly, thousands of shops were in private hands and in need of kryshas. By 1994, the majority of Soviet firms had been privatized in a rapid giveaway of industrial assets. Many of these enterprises proved to be valuable targets for criminal groups, and simultaneously in desperate need of protection services.

The services for which firms relied on criminal protection rackets continued to evolve. Bandity became involved in the enforcement of contracts, collection of debt, and intelligence gathering on prospective business partners. In the absence of an effective court system, they began to play an adjudicative role. The krysha of one firm would meet with the krysha of another to negotiate on behalf of their respective clients, or, if need be, to resolve the dispute by force. For longstanding or complex disputes, bandity would turn to criminal leaders, known as avtoritety, and to vory v zakone, who served as arbiters in what became a system of “shadow justice” (Skoblikov 2001).

Alarming estimates of the influence of organized crime on the Russian economy soon became widespread. A Ministry of Interior (MVD) report released in 1994 claimed that up to three-fourths of Russian businesses paid protection money, with the banking sector particu-

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larly under the sway of organized crime groups. The Russian Academy of Sciences (RAN) reported in 1995 that criminal groups held 55 percent of capital and 80 percent of voting shares in private enterprises (Webster 1997, 2-3). These studies became the basis for dire assessments of organized crime in Russia by Western analysts (e.g., Shelley 1997; Webster 1997), although the imprecise distinction among protection, control, and ownership of enterprise assets in these reports complicates assessment of their validity (Volkov 2002, 97-98). Regardless, the reality of harsh violence during this period was undeniable, including extensive contract killings, car bombs, and all out gang wars on the streets of cities such as Moscow, Ekaterinburg, and Kazan. Shocking tales emerged. Reputedly, the FBI traced connections of a well-known vor directly to the Kremlin (Shelley 2007), while the journalist Seymour Hersh (1994) reported that criminal rackets even controlled access to the passport line at the U.S. Embassy.

Along with criminal protection rackets, private security agencies played a major role in property security in the early 1990s. These agencies emerged in the aftermath of the collapse of the mammoth Soviet security structures, in particular during the reorganization of the KGB, which created a supply of highly-trained unemployed security specialists. In 1992 the government passed the Law on Private Detective and Protection Activity and issued a concomitant government decree, legalizing the formation of private security structures, a process that was already de facto underway. Private protection enterprises (chastnoe okhrannoe predpriyatie), known widely by their Russian acronym as ChOPs, soon became a major facet of the Russian business world.

In and of itself, the emergence of a large private security sector was unremarkable. Other countries have private security agencies, including the United States and Britain. But the key difference was that “in Russia, the activity of private protection agencies extended beyond mere physical or informational security and into the sphere of business transactions and civil property relations” (Volkov 2002, 141). ChOPs offered a long list of services: debt collection, physical protection, collection of data on lawsuits, market research, information on future business partners, protection of trademarks and commercial secrets, and investigations of future or current employees.

The private security sector grew rapidly. By 1993, there were already approximately 5,000 registered private security agencies. This number doubled by the end of the decade, doubled again by 2005, and today is estimated at around 30,000 agencies. Yet despite the growing number of private security agencies, the role of private force in the Russian business world has declined dramatically. Evidence that economic conflicts are less likely to be settled by violence appears in the statistics on annual murders of businesspeople, as seen for Russia’s Central Federal District in Table 2.1. The numbers remain high by Western standards and indicate that Russia is still a rugged place to do business, but they also show a significant

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positive trend compared to Russia’s recent bloody past. Meanwhile, most experts concur that reliance on contract killings declined after the early-to-mid 1990s (Krylov and Krylov 2008; Skvortsova 2000). Contract killings persist to this day, but observant analysts have recognized that an increasing number of targets are outside the sphere of property disputes. While businessmen, bankers, and bureaucrats with control over valuable licenses or permits are still prevalent among the victims, a rising proportion of contract killing targets are journalists and human rights activists (Kommersant 2008; Ram 2009; Skvortsova 2000).

Businesspeople themselves corroborate this decline in physical violence. A survey conducted by Radaev (1999) of 221 enterprise managers across 21 Russian regions in 1997 revealed that approximately two out of five respondents reported personally experiencing violent extortion or threats of physical coercion. Businesspeople, however, seemed to be sensing a turning point: Only 14 percent said the risk of threats and extortions was getting worse, whereas 30 percent said it was getting better (Radaev 1999, 36-40). Indeed, my survey of 301 firms from eight Russian cities, conducted in June and July of 2010, validates these optimistic prognoses: Less than five percent of respondents said they or their employees personally had been subjected to threats or physical coercion.

Survey evidence paints a similar picture with respect to the disappearance of criminal protection rackets. Frye and Zhuravskaya (2000) found in a 1996 survey of 230 small retail shops in Moscow, Ulyanovsk, and Smolensk that over 40 percent of respondents reported having contact with a criminal group in the last six months; a survey of shops conducted in the same three cities two years later found the respective figure to be less than 25 percent.

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4 Contract killings in general are tough to measure, and different sources report drastically varying statistics, not least of all because in the early 2000s the MVD began reporting only the number of solved cases rather than the number of registered contract killings (Vlast 2008).

5 Matveeva (2005) notes that while these statistics refer to overall murders of businesspeople, her analysis of the data indicates that all but approximately five percent of these deaths were related to the victims’ business activities.

6 To facilitate comparisons, information regarding the samples for all surveys cited can be found in Appendix 1 at the end of this chapter.
Surveys conducted by the Russian business association OPORA (2005, 91; 2006, 52) in 2004 and 2005 across 80 of Russia’s 89 regions found that well under ten percent of small businesses during these years reported frequent contact (although between 30 and 40 percent reported some “irregular” contact). By contrast, my 2010 survey found that less than 8 percent of 105 small businesses in the sample (and less than 4 percent of the 301 firms in the overall sample) reported contact with criminal protection rackets at any point in the last three years.

Most telling in terms of the evolution of property security strategies, firms in the late 1990s were beginning to indicate a clear preference for strategies other than reliance on criminal protection rackets. Radaev’s 1997 survey found that in response to threats and extortion, only 15 percent of respondents would turn to criminal groups, while about the same number would turn to the police. The largest category of respondents, 34 percent, said they would rely on themselves to deal with the threat (Radaev 1999, 42-43). OPORA’s 2004 survey similarly found that only 14 percent of small firms reported they would turn to a krysha for help should they face a violation of their rights (OPORA 2005, 70-71). As discussed below in the section on legal institutions, the results of my survey indicate that this trend away from private force has only continued.

The extent to which criminal kryshas have become a thing of the past is perhaps best summarized by the co-founder of a prominent Moscow private security agency, himself a former Ministry of Internal Affairs agent specializing in fighting organized crime. In the early 1990s, he explained, the majority of his firm’s work involved helping clients deal with bandity. By 1995, a noticeable shift was occurring: “...criminal groups were disappearing to such an extent that they were becoming simply something exotic. If a client came to us and said that some bandity from the street had tried to extort him, well, this was for us something exciting. [It gave us] a sort of nostalgia for the old days” (author interview, 18 September 2009, 091809-SF5). The challenges his security firm faces have continued to evolve, and he noted that today it is even more rare to encounter criminal protection rackets.

The shift away from private force is also apparent in the private security sector. In the 1990s, the line between ChOPs and criminal groups was often blurry. Some private security agencies used criminal methods to collect debts and, in some cases, directly extorted businesspeople. In other cases, criminals themselves formed ChOPs in order to legally carry weapons. Some estimates claim that around 15 percent of ChOPs in the late 1990s had criminal ties (Volkov 2002, 143). Moreover, businesspeople at times turned to ChOPs with explicit demands for illegal activities, including physical attacks and kidnapping (Shebaldin 2007). The fact that for many years numerous ChOPs, accounting for as many as 150,000 employees, remained unregistered and out of the gaze of the state facilitated the persistence of questionable practices (Khodorych 2002; Pistor 1996, fn. 91).

Yet even if firms’ shift from criminal protection rackets to ChOPs did not initially entail the complete elimination of criminal elements from the market for private security, it brought
about significant changes. ChOPs were willing to apply force but were more likely than bandity to do so only as a last resort. They focused more on conflict prevention and in place of violence often applied pressure to a client’s competitors by gathering compromising materials, known in Russian as kompromat, which could be used for blackmail. They worked on the basis of formal contracts and usually paid taxes to the state. They had to legally register with the MVD and could have their license revoked if they violated laws and regulations. They encouraged clients to understand and abide by the laws, and they organized business associations to screen out criminal enterprises masquerading as legitimate security agencies (Pravotorov 2006; Volkov 2002, 142-143, 147, 151-152).

As private security agencies brought legitimacy to the market for protection, they simultaneously became more specialized as providers of physical security and less frequently a substitute for state institutions. Today, the word ChOP narrowly refers to security guards, whereas the term krysha has a clear connotation of criminal connections. Experts estimate that provision of basic physical security accounts for 70 percent of the private security sector’s revenues, the rest consisting of information security, legal services, and installment of security systems (cameras, alarms, etc.). Although there has been recognition that profit margins for providing detective services, such as investigating credit histories and locating debtors, are quite high, these services account for a negligible fraction of ChOPs’ work (author interview with Ivanchenko; Khodorykh 2002).

Meanwhile, the security concerns of Russian businesspeople have evolved dramatically. Today, “economic security” entails a wide range of threats, including information security, such as computer virus attacks by competitors; espionage by employees with ties to other companies; raids that use complicated legal schemes to acquire assets; and unwarranted inspections (naezdy) by government regulators, some of which are instigated by competitors. To address these sophisticated threats, firms specializing in economic security rely far more on lawyers, accountants, IT specialists, and former law enforcement officials than on the application of violence and force.

Survey research indicates that this trend toward specialization was already beginning by the late 1990s. A 1997 survey by Hendley et al. (2000, 643) of 328 industrial firms from six regions found that even though half of the respondents utilized the protective services of a security agency, less than three percent of respondents relied on these firms to prevent or resolve problems with suppliers or for evaluating the credit-worthiness of customers. They concluded: “These results suggest that security agencies have the more prosaic mandate of

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7 This statement was corroborated without exception in interviews with businesspeople and security specialists. In a typical response regarding the functions of ChOPs, one small businessperson in Moscow explained: “ChOPs? Those are just the guys that stand outside and guard the door” (author interview, 10 February 2009, 021009-F1).

CHAPTER 2. FROM FORCE TO LAW

Figure 2.1: Firms’ Use of Private Security (past 3 years)

Of firms using private security, % using for the following purposes:

- Employee Background Check
- IT Security
- Debt Collection
- Contract Violations
- Property Dispute
- Physical Threats
- Conflict with Tax Authorities
- Other

- Internal Security Service
- Private Security Agency

protecting money or property, rather than the task of enforcing contracts through intimidation of trading partners” (Hendley et al. 2000, 643). In a 2001 survey of 304 open joint-stock companies in Moscow, Tomsk, and Nizhniy Novgorod, Yakovlev et al. (2003, 71) reported that only five percent of respondents whose legal rights had been violated turned to ChOPs to help resolve the problem. Likewise, in the 2010 survey I conducted, less than 10 percent of respondents reported using the services of a private security agency for any reason in the last three years.

On the other hand, 33 percent of firms in my survey, and approximately 45 percent of firms with over 100 employees, reported using their own internal private security service at some point in the last three years to resolve a security issue. But as seen in Figure 2.1, the reasons that firms turn to private force reflect a very different type of threat than the property disputes of the 1990s. Primarily, firms use private security for dealing with internal problems pertaining to employees and the security of information technology systems. For example, of the 100 firms in the survey sample that report using an internal security service in the last three years, 52 percent used this service for issues related to IT security, while 73 percent used the service to run employee background checks. Such issues as debt collection, contract violations, and property disputes represent a significantly smaller share of the services for which firms turn to private force.

In summary, the era of overt private violence and coercion as a widespread tool of mainstream businesspeople has come to an end. Organized crime today remains a significant

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9 Of the 301 firms in the survey, 27 report using a private security agency and 100 report using an internal security service in the last three years.
problem in illegal sectors, but legitimate businesses rely on bandity for protection, adjudication, and contract enforcement services almost exclusively in remote and underdeveloped regions (Pravotorov 2006; Volkov 2002, 152). Analysts sometimes speak of a “criminalized” society in which organized crime groups have established formidable contacts within the Russian bureaucracy and security agencies to protect their illicit activities (Dolgova 2005; Shelley 2007). Yet such corruption and crime is fundamentally different than a situation in which criminal groups substitute for state institutions on a massive scale. To the extent that firms continue to rely on force instead of law, they resort to corrupt force — the use of state resources for private purposes — rather than private force.

2.2 Persistence of Corrupt Force

As Russian firms’ turned away from private force in the mid-to-late 1990s, they began to utilize a host of strategies that relied on the corrupt appropriation of state resources. Foremost among these was the protection rackets offered by law enforcement officials (known as a mentovskaya krysha as opposed to a banditskaya krysha, the term for a criminal protection racket). Law enforcement protection rackets offered many of the same services previously provided by criminal protection rackets, such as debt collection, contract enforcement, and adjudication of disputes. Another prominent tool based on the corrupt use of state resources that arose in the mid-to-late 1990s was the “ordered inspection” (zakaznoi 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. Corrupt notaries and judges also figured prominently in these strategies, especially in disputes involving illegal corporate raiding (reiderstvo), which became a major source of conflict in the late 1990s and early 2000s in Russia. These property security strategies involving corrupt force persist to the present day, intermingling with the legitimate use of formal state institutions.

Law enforcement protection rackets took many forms. The most sought after law enforcement kryshas were the Ministry of Internal Affairs’ (MVD) State Directorate for the Struggle with Organized Crime (GUBOP) and its regional branches (RUBOPs), as well as FSB (the KGB successor) units devoted to economic and organized crime. Though these services were semi-legal at best, this is not to say that these units were entirely criminalized. For example, GUBOP leaders in part saw provision of private security as a way to finance their unit amid a collapse in state revenues during the 1990s. Reportedly, money earned was put back into the department and used for cars, equipment, and subsidized meals for personnel. Often the charity organizations connected to these security agencies doubled as private security agencies, while simultaneously providing genuine charity for veterans and family members.

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10 Mentovskaya comes from the term menty, which is a common but semi-derogatory term for police.
of the security services (Pravotorov 2006; Sborov 2003). Lower levels of police also got into the fray. Some estimates suggest that approximately 30 percent of MVD personnel offered some form of krysha in the 1990s (Webster 1997, 30).

The line between legitimate and illegitimate use of state resources for the purpose of property security was further obscured by the role of the extra-departmental security division (vnedomstvennaya okhrana) of the MVD, known as the VO. Founded during the Soviet period to guard state property, it received the right to provide commercial services in 1992. While analysts have devoted extensive attention to the role of Russian private security agencies, VO guards have actually formed a larger slice of the private security market, both in terms of personnel and the number of objects guarded (Brusov 2007; Khorodykh 2002; Lashkina 2007; Orlov 2008a, 2008b). This remained true until 2005, when a quasi-state enterprise, FGUP Okhrana, was spun-off from the VO. For businesspeople, VO guards were an enticing option, for they had the advantage of wearing police (militsia) uniforms and being able to carry any type of gun, unlike the limited arsenal allowed to ChOPs (Khodorych 2002; Orlov 2008a, 2008b).

By the late 1990s, there was no question that firms had come to depend almost fully on state officials, or on private security agencies with ties to the state, for protection services. Observers estimated that criminal kryshas maintained control of around 10 to 20 percent of the total market for private security, while ChOPs and law enforcement protection services divided up the remaining clients (Khodorych 2002; Skoblikov 2001; Taylor 2006, 45; Volkov 2002, 169-170). One journalist summarized the situation as follows: “By the end of the 1990s, the majority of entrepreneurs capable of making money were ‘voluntarily’ providing support to the law enforcement authorities. It could be said that the country had been divided into zones of ‘police patronage’ [militseiskoi otvetstvennosti]” (Sborov 2003). Internal cables from the U.S. Embassy in Moscow to the State Department in Washington came to a similar conclusion: “Moscow business owners understand that it is best to get protection from the MVD and FSB (rather than organized crime groups) since they not only have more guns, resources and power than criminal groups, but they are also protected by the law. For this reason, protection from criminal gangs is no longer so high in demand” (New York Times, 1 December 2010). Among those using state security services, small firms primarily turned to the MVD, large firms to the FSB, and the MVD and FSB divided medium-sized clients nearly equally (Pravotorov 2006).

State protection rackets were not limited to law enforcement agencies. Bureaucrats also proved to be valuable sources of protection, particularly as harassment by state officials came to replace physical threats as a major concern for many firms. As a Moscow lawyer explained, a well-placed bureaucrat (known as a pokrovitel, a “protector” or “patron”), sometimes serving as a shareholder on a firm’s board of directors, could at times offer better protection from overzealous tax authorities or inspectors than could law enforcement officials (author interview, 5 May 2009, 050509-L17; also see Pravotorov 2006). Having judges
and notaries willing to intervene in business disputes for the proper price also became an essential component of some property security strategies, particularly for illegal corporate raiding (*reiderstvo*), as discussed later in this chapter.

The services which law enforcement and other government officials provided to firms went far beyond mere protection. Businesspeople learned that there were safer, more efficient means than private force to undercut competitors or settle disputes — namely, to “order” (*zakazat*) an investigation by a government agency. In the words of one businessperson, “In the past, if someone refused to pay they could damage the shop or just burn it. Now they’ve understood that it is cheaper and safer to get fire inspection to close it down for a week or two. And the effect is the same” (cited in Volkov 2002, 51; also see Radaev 1999, 48). An even more fearsome tool described by some Russian businesspeople was the “ordered” criminal investigation, whereby a competitor or counterparty in a dispute would bribe a prosecutor to open a criminal case. Rather than the loss of financial resources or property, victims of an ordered criminal investigation faced an extreme form of pressure — the threat of a prison sentence. Once the victim agreed to settle a dispute on terms favorable to the attacker, the criminal investigation abruptly would come to an end (author interviews, 022709-F6,102209-F29).

Precise measures of the use of corrupt force are for obvious reasons difficult to obtain. Whereas earlier surveys sought to quantify the extent of criminal protection rackets, much less attention has been paid to firms’ corrupt use of state resources. The 1997 Hendley et al. (2000, 635-636) survey introduced above found that about 14 percent of purchasing departments reported seeking intervention from government agencies to resolve problems with suppliers, while approximately 22 percent of sales departments turned to government agencies to address disputes with customers. From these figures they concluded that “few enterprises look to the state for help in solving problems with customers and suppliers” (Hendley et al. 2000, 643). Yakovlev et al.’s (2004) survey conducted in 2002 found that among the open joint-stock companies surveyed, 11 percent would turn to government officials to resolve an economic dispute. The 2004 survey of small businesses conducted by the business association OPORA found that in response to a violation of legal rights, a surprisingly large 52 percent of respondents would look to intermediaries with government connections (OPORA 2005, 71). Likewise, when faced with threats or use of violence, 28 percent of small businesses said that the most common response in their region was to rely on ties with government officials (OPORA 2005, 93).

Whereas these studies paint a mixed picture regarding government officials’ role in property security strategies, my 2010 survey indicates that corrupt force remains a significant part of property security in today’s Russia. Additionally, unlike previous studies, my survey sought to explicitly distinguish between the legal and illegal use of state resources. When respondents were asked about the extent to which their property security strategies rely on law enforcement agencies, members of the judiciary, and government officials (e.g., inspectors,
regulators, and other bureaucrats), they were also asked to clarify whether they sought support from these officials in an official capacity or in a private capacity.\textsuperscript{11} As Table 2.2 indicates, official use of bureaucrats and law enforcement agents averaged around 30 percent, while informal use reached nearly 20 percent. Meanwhile, while nearly half of all firms reported using the courts in the last three years, nearly 15 percent admitted that they also used informal connections within the judicial system. To the extent that respondents may be prone to underreport informal use, these figures should be considered a lower bound and therefore indicate that the corrupt use of state resources is far from insignificant.

In summary, the switch from private force to corrupt force represents significant change. While it is not indicative of a wholesale shift from protecting property claims to enforcing property rights, observers of the Russian business world often perceive it to be a positive transformation. In the words of one Russian journalist, “the classic krysha irreversibly is becoming a thing of the past. In our day ‘protection’ of businesses appears to be more civilized” (Pravatorov 2006). The reduction in physical violence is indisputably an encouraging phenomenon. But whether the use of corrupt force is a step along the path to legitimate use of state institutions or an occurrence that will mire state institutions in long-term corruption

\textsuperscript{11}The phrasing was formulated based on the author’s experience conducting in-depth interviews with Russian businesspeople and private security agencies. The questions were piloted extensively before conducting the actual survey. The goal was to identify phrasing that was not directly incriminating yet was immediately recognizable among Russian businesspeople as an allusion to government protection rackets or similar types of corrupt force. For law enforcement officials and bureaucrats, respondents were asked to clarify whether they used these resources in an “official capacity” (obratitsya kak k dolzhnostnym litsam) or “unofficial capacity” (obratitsya kak k chastnym litsam). For judicial officials, respondents were asked if they went to court fully in a “formal manner” (v formalnom poryadke) or whether they also used “informal connections” (s ispolzavaniem sushchestvuyushchich tam svyazej).
remains to be seen, an issue discussed at greater length in the concluding chapter.

2.3 Development of Delegated Law

In all economies, no matter how developed, enforcement of property rights is not left solely to formal state institutions. A wide range of private mechanisms help sustain transactions, reducing costs to societal actors and alleviating the burden placed on government officials. Unlike the use of force, these mechanisms usually complement rather than undermine formal institutions. In many cases, the authority of these private institutions explicitly is codified by law: The state delegates authority to private actors so that they can help enforce the rules that underlie modern market economies. For example, laws on private arbitration and mediation allow non-state actors to make legally binding decisions; likewise, in some societies, business associations are endowed with regulatory powers that would otherwise fall to a government agency. In other words, these strategies represent a form of delegated law. Property security strategies based on delegated law remain underdeveloped in Russia, but as the examples of business associations and private arbitration indicate, there is evidence that they are beginning to emerge.

Following the collapse of Soviet Union, numerous business associations appeared. However, the vast majority of these associations were created by government officials to maintain control over firms during the process of privatization or to lobby for the interests of firms still owned by the state. With few exceptions, primarily the Union of Russian Industrialists and Entrepreneurs (RSPP), business associations during this period played a minimal role, both with respect to politics and in terms of property security strategies (Hanson and Teague 2005; Markus 2007). Hendley et al.’s 1997 survey found, for example, that less than 5 percent of firms turned to business associations for help resolving conflicts with suppliers or customers (2000, 635-636); similarly, less than 10 percent of firms in Yakovlev et al.’s 2002 survey had used a business association to help resolve an economic dispute (2004, 71). Nearly a decade later, the findings of my 2010 survey seem — at least at first glance — to indicate that little has changed. Only 12 percent of firms reported using a business association in the last three years to resolve a security-related problem.

Despite these indicators, there is evidence that demand for delegated law is growing. First, beginning in the late 1990s, analysts noted an influx of firms into business associations. Pyle’s 2003 survey of 1353 enterprises across 48 regions of Russia found that approximately 35 percent of firms were business association members; in a more detailed follow-up survey of 606 firms, he concluded that number of firms joining associations in the early Putin period (2000-2003) was nearly twice that of the late Yeltsin period (1996-1999) (Pyle 2005,
Table 2.3: Number of Cases Related to Private Arbitration Heard by Commercial Courts, 2002-2009

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of cases</td>
<td>672</td>
<td>936</td>
<td>1287</td>
<td>1593</td>
<td>1704</td>
<td>1710</td>
<td>2113</td>
<td>3770</td>
</tr>
</tbody>
</table>

Source: Supreme Commercial Court of the RF.

The fact that a significant percentage of firms hold membership in business associations indicates that firms see some value in these organizations.

Certainly, larger associations exist primarily as lobbying machines. In the late 1990s, for example, Russia’s most powerful business tycoons turned RSPP into a tool for promoting banking, currency, administrative, judicial, and other institutional reforms (Hanson and Teague 2005). Lobbying, however, is not necessarily the primary goal of associations representing smaller firms. One significant aim of OPORA, the association of small businesses formed in 2001, has been to protect its members’ property rights. In 2003, OPORA created a Bureau for the Oversight of Entrepreneurs’ Rights, which offers free legal advice and a hotline for firms facing unwarranted inspections by government officials. The head of the Bureau explained that the project was undertaken after OPORA representatives announced in a Moscow newspaper that they would provide several days worth of free legal advice for small businesses by phone. After their phone banks were flooded with calls, OPORA decided that the unexpectedly high demand for such services warranted a permanent Bureau (author interview, 9 April 2008).

OPORA’s experience is not an isolated incident. Pyle’s 2003 survey discovered that on average, firms’ rated the need to receive “informational, legal, and consulting services” as the most important reason to join a business association; they rated “protection from illegitimate government interference” as the third most important reason (Pyle 2009, 13). As further evidence that business associations play a key role in property security, Pyle (2009) found that business association members are more likely than non-members to appeal illegitimate government inspections to a court or another government body, while Markus (2009) demonstrated that members of business associations are more likely than non-members to believe that their property rights are secure.

In addition to providing legal advice and helping members defend property rights, business associations have been one source of private arbitration services (третейский суд), providing a non-state forum for resolving business conflicts. For example, in 1992 the Chamber of Trade and Industry (ТПП) created one of the first courts of private arbitration, which remains active.

\(^{12}\) 41 percent of respondents in my survey report being a member of a business association.
today.\textsuperscript{13} Private arbitration and mediation is not limited, however, to services provided by business associations.

Although temporary legislation laid the foundation for private arbitration at the outset of the post-Soviet transition, it was not until the 2002 Law on Private Arbitration that it was fully incorporated into the Russian legal and business worlds. In 2002, experts estimated that there were just over 400 courts of private arbitration. By 2007, similar estimates put this number somewhere between 700 and 1000 (Sevastyanov and Tsyplenkova 2007, 63). A unified source of data on private arbitration courts does not exist, but data from individual courts indicates that demand for private arbitration — although still low — in recent years has been rising, particularly during the economic crisis of 2009. In some cases, this growth has been dramatic: the Federal Court of Private Arbitration [\textit{Federalnyi treteiskii sud}] heard 72 cases in 2008, 364 cases in 2009, and 956 cases in 2010.\textsuperscript{14} Further evidence of increased demand for arbitration services can be seen in the data on the number of cases from private arbitration that have been disputed or for which enforcement has been sought via the official commercial court system. Between 2002 and 2009, these cases increased sevenfold, from 672 to 3770, as shown in Table 2.3.\textsuperscript{15} Meanwhile, in 2006, the first All-Russian Congress of Private Arbitration Courts took place, and conferences and seminars on arbitration and mediation have become commonplace (Sevastyanov and Tsyplenkova 2007). Evidence of rising interest in private arbitration can also be seen in the emergence of specialized professional journals such as \textit{Treteiskii Sud}.

In summary, delegated law does not play the significant role that it plays in developed economies, but it is beginning to emerge, contributing to the shift from protecting claims to enforcing rights.

### 2.4 Rise of Institutionalized Law

In the early 1990s, Russian businesspeople rarely utilized formal legal institutions. The Soviet Union had little tradition of politically independent courts, and it naturally had no mechanisms for adjudicating disputes among private firms operating in a market economy. Yet since the mid-1990s, significant evolution in demand for formal legal institutions has

\textsuperscript{13}The history of the TPP’s private arbitration court can be found at http://www.tpprf-arb.ru/ru/tsec. For additional examples, see Sevastyanov and Tsyplenkova (2007, 65).


\textsuperscript{15}Russian legal scholars express confidence that this increase did not result from growing problems with the enforcement of private arbitration decisions but instead reflects a genuine increase in the use of private arbitration (e.g., author interview with Petr Skoblikov, Professor of Law, Ministry of the Interior Academy of Management; see also Sevastyanov and Tsyplenkova 2007, 65).
taken place in Russia. Caseload data, survey data, and in-depth interviews with businesspeople and lawyers indicate a substantial change in firms’ willingness to rely on property security strategies based on institutionalized law.

At the outset of the 1990s, Russia replaced Soviet institutions with a two-track judicial system. Commercial courts (arbitrazhnye sudy) were built on the remnants of the former gosarbitrazh system, an administrative dispute resolution forum for Soviet enterprises. These courts were tasked with economic disputes and administrative conflicts between firms and the state. The courts of general jurisdiction (sudy obshchei yurisdiktsii) were set up to handle civil litigation and criminal matters. By the mid-1990s, a new Arbitration Procedural Code, Civil Code, Law on Joint-Stock Companies, Law on the Securities Market, and other legislation essential for the functioning of a market economy also had been established.

Despite reforms, many Western and Russian analysts continue to argue that firms circumvent formal legal institutions, which they perceive as slow, corrupt, or incapable of enforcing court rulings (e.g., Edwards 2009; Skoblikov 2001; Tolstych 2005; Volkov 2002). Yet by the mid-1990s, firms’ reliance on the commercial courts was already increasing, and as shown in Figure 2.2, use of these courts had reached significant levels by the early 2000s. While a rising number of court cases can result from a growing number of violations of firms’ rights rather than increased willingness to rely on legal institutions, survey data suggest this was not the case. For example, Yakovlev (2008) finds that between 2000 and 2007, there was a decline in the extent of legal violations reported by firms. Indeed, it strains credulity to argue that the late 1990s and early 2000s were a period in which firms found themselves more in conflict than in the early-to-mid 1990s.

Moreover, extensive evidence indicates that firms genuinely have begun to change their perception and use of the courts. According to the 2010 survey I conducted, 54 percent of respondents reported that in response to violations of their legal rights, they would be more willing or significantly more willing to turn to the courts today as compared to 10 years ago. (33 percent of respondents said that their willingness to use the courts remained unchanged, and only 6 percent of respondents replied that they would be less willing). Overall, a host of surveys indicates that Russian firms now utilize formal legal institutions quite extensively, with about one-third of smaller firms and two-thirds of larger firms having

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16 The consistent exception has been Kathryn Hendley. See, for example, Hendley (2006).

17 Figure 2.2 excludes administrative cases initiated by government authorities, as these cases have little to do with demand for law from the side of firms. For additional information on these cases, see Appendix 2 at the end of this chapter. Data are from reports of the Vysshyi arbitrazhnyi sud [High commercial court]: Svedeniya o rassmotrennykh sporakh s uchastiem nalogovykh organov [Report on cases with the participation of the tax authorities]; Spravka osnovnykh pokazatelei raboty arbitrazhnykh sudov RF [Information on the basic indicators of the work of the commercial courts]; Spravka o rassmotrenii arbitrazhnimi sudami RF del, voznikayushchikh iz administrativnykh pravoootnosenii [Information about cases arising from administrative law considered by the commercial courts]. Recent data are available at www.arbitr.ru; older data were obtained directly from the VAS.
Figure 2.2: Annual Number of Cases Initiated by Firms in Commercial Courts, 1992-2009

Source: Data are from reports of the Vysshii arbitrazhnyi sud [High commercial court].

used the commercial courts (Johnson et al. 2002; OPORA 2005, 2006; INDEM 2009, Table 2.1; Yakovlev 2008; Yakovlev et al. 2004, 69). Even more telling than overall usage of the judiciary, however, is the percentage of firms reporting violations of their economic rights that utilized the court system. Yakovlev and Frye’s 2000 and 2007 surveys of 500 firms in seven regions found that of those experiencing a violation, 66 percent in 2000 and 72 percent in 2007 turned to the courts (Yakovlev 2008).

An additional indication of the growing reliance on legal institutions is firms’ increasing willingness to use legal remedies even in disputes with state authorities. Turning to formal state institutions when one’s adversary is the state itself indicates a significant degree of reliance on institutionalized law. To be sure, firms are more skeptical of the effectiveness of the judicial system when the state is involved. A range of surveys conducted in the early-to-mid 2000s show that over 70 percent of firms respond affirmatively when asked whether they can defend their rights in court against other private actors, yet only around 40 percent suggest that the same is true when a state agency is the opposing party (Yakovlev 2008; Yakovlev et al. 2004, 81). Nonetheless, between 2000 and 2008, cases against the tax authorities rose from around 13,000 to over 50,000, a 280 percent increase. Cases against other government funds and agencies increased during this period from around 11,000 to
40,000. By 2009 litigation against the state represented nearly 20 percent of all cases initiated by firms, as seen in the rise in cases against the state in Figure 2.2. Nor were these suits hopeless endeavors. Win rates for plaintiffs in cases against tax authorities grew from around 60 percent at the end of the 1990s to above 70 percent in the late 2000s.¹⁸

Actual litigation rates are, of course, only the proverbial tip of the iceberg (Hendley 2001). For any dispute that ends up in court, countless others are negotiated in “the shadow of the law,” where the threat of litigation shapes negotiations (Mnookin and Kornhauser 1978). The increased use of the court system thus captures only a fraction of the actual increase in reliance on lawyers, legal strategies, and the legal system. But there is broader evidence that lawyers and law have come to play an increasingly important role in the Russian business world.

Lawyers themselves, for example, see significant changes in their profession and its role in business. As one of Russia’s top tax lawyers recalled, today there is booming demand for his services, whereas in the 1990s his “…main problem was not winning, but convincing businesspeople that it is worth going to court” (author interview, 5 November 2009, 110509-L21). According to a prominent bankruptcy lawyer in Moscow, one of the reasons for this hesitancy was that “…lawyers here are part of a very young profession. In the 1990s businesspeople thought of them as con-men (moshenniki).” He continued to explain, however, that today the “…image of lawyers more broadly has changed. They are like advisors now, not only for legal stuff but more generally in business” (author interview, 4 March 2009, 030409-L3). Other lawyers find evidence in the changing attitudes of businesspeople toward lawyers in more subtle indicators. A young litigator, for example, suggested that “the very fact that, unlike in the 1990s, firms are willing to pay for services even when they lose is a strong indicator of the development of legal consciousness and reliance on law; in the 1990s they wanted a concrete result before they would pay lawyers anything” (author interview, 29 October 2009, 102909-L20). Nor is this development limited to Moscow. When asked about the extent to which firms now use the court system, a lawyer from the Siberian town of Barnaul observed that “…people more or less have come to resolve disputes in a civilized way, by going to court.” Indeed, he noted that the courts are so packed with litigants that “…to move through the corridors of a courthouse is now impossible” (author interview, 30 September 2009, 093009-L22).

Another indicator of the expanding role of law in the Russian business world is the growing population of lawyers (Hendley 2006, 364). The legal community in Russia is divided among advokaty and yuristy, and only the former are required to take a bar exam and pay bar membership dues.¹⁹ Therefore, only the exact number of advokaty is known, even though

¹⁸These data are based on the sources listed in footnote 17.

¹⁹The distinction is a holdover from Soviet times, during which advokaty were the rough equivalent of defense attorneys, and yuriskonsulty were the rough equivalent of in-house counsel. Today, the distinction between the two is less clear cut. Only advokaty can represent a client in a criminal case, but advokaty also regularly
they represent the minority of all lawyers. Among advokaty, there has been a dramatic increase, from 26,300 in 1996 to 63,740 in 2010, a 140 percent change, even though during this period the overall population of Russia was declining. The growing role of lawyers can also be seen in the increased size of legal departments. In Hendley et al.’s 1997 survey, 45 percent of firms had an internal legal department, but their study suggested that these legal departments were largely unreformed from the Soviet period and continued to play a routine and insignificant role in Russian business practices. These legal departments ranged in size from 1 to 17, with a mean of 2.5 (Hendley et al. 2001a, 690, 693). My 2010 survey similarly found that just over 40 percent of respondents had an internal legal department. But the size ranged from 1 to 250, with a mean of around 10 lawyers, even though on average the firms in my sample were smaller. Clearly, firms with several hundred lawyers consider legal resources to be an important asset.

The most striking evidence of demand for institutionalized law, however, is how firms evaluate their reliance on lawyers and courts relative to other property security strategies. Even by the late 1990s, firms seemed to consider use of the courts to be a relatively attractive option when compared with other strategies for resolving conflicts. Hendley et al.’s (2000, 635-636) 1997 study found that with the exception of direct enterprise-to-enterprise formal negotiations, turning to the courts was the most common way of addressing contractual problems with suppliers; likewise, other than stopping trade with a customer, litigation was the most common way of dealing with customer conflicts. Yakovlev et al. (2004, 70) found similar results with respect to open joint-stock companies’ preferred methods of dispute resolution: Turning to the courts was stated as a preferred choice by over half of the respondents, and threatening to turn to the courts by over twenty percent.

My survey indicates that these trends toward reliance on institutionalized law have continued, as seen in Table 2.4. When respondents were asked to rank on a 1 to 7 scale how likely a firm like theirs would be to utilize various strategies to resolve an asset dispute (with 7 meaning “very likely” and 1 meaning “very unlikely”), the highest ranking strategies were the use of lawyers to resolve the conflict out of court (average ranking 6.0) and filing a claim in the commercial courts (5.7). These ranked higher even than direct negotiations with the

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serve corporate and business clients. By law, however, they must work for an independent law firm and cannot serve in-house. For some background on the structure of the Russian legal profession, see Hendley (2010, 8-9).

20Biannual data from 1996-2004 on the number of registered advokaty can be found in Hendley (2006, 385). For more recent data, see Federalnaya palata advokatov [Federal Chamber of Lawyers] (2010, 32).

21 The Hendley et al. sample had firms ranging from 30 to 17,000 employees, with a mean of 980 and median of 300. The firms in my sample ranged from 3 to 9,000 employees, with a mean of 390 and median of 200. Even excluding firms in the survey sector, to make the two samples comparable, firms in my sample range from 6 to 9,000 employees, with a mean of 520 and median of 300 employees. The average and median size of law departments in the non-service subsample is almost identical to the average and median for the overall sample.
Table 2.4: Firms’ Preferred Property Security Strategies

Average responses on a scale of 1 to 7, where 1 is “very unlikely” and 7 is “very likely”

<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td><strong>Institutionalized Law</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rely on lawyers to resolve the dispute out of court</td>
<td>6.04</td>
<td>(299, 0.09)</td>
<td></td>
</tr>
<tr>
<td>Turn to the commercial courts</td>
<td>5.69</td>
<td>(295, 0.10)</td>
<td></td>
</tr>
<tr>
<td>Seek the help of law enforcement officials acting in their formal capacity</td>
<td>5.18</td>
<td>(297, 0.12)</td>
<td></td>
</tr>
<tr>
<td>Seek the help of government bureaucrats acting in their formal capacity</td>
<td>4.57</td>
<td>(292, 0.12)</td>
<td></td>
</tr>
<tr>
<td><strong>Corrupt Force</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Turn to the commercial courts, using informal connections</td>
<td>4.32</td>
<td>(270, 0.14)</td>
<td></td>
</tr>
<tr>
<td>Seek the help of law enforcement officials acting in an informal capacity</td>
<td>3.78</td>
<td>(282, 0.13)</td>
<td></td>
</tr>
<tr>
<td>Seek the help of government bureaucrats acting in an informal capacity</td>
<td>3.63</td>
<td>(283, 0.13)</td>
<td></td>
</tr>
<tr>
<td><strong>Delegated Law</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Settle the dispute in a private arbitration forum</td>
<td>3.21</td>
<td>(271, 0.13)</td>
<td></td>
</tr>
<tr>
<td>Seek the help of a business association</td>
<td>2.76</td>
<td>(260, 0.13)</td>
<td></td>
</tr>
<tr>
<td><strong>Private Force</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rely on an internal security service</td>
<td>3.29</td>
<td>(274, 0.14)</td>
<td></td>
</tr>
<tr>
<td>Seek the help of a private security agency</td>
<td>2.21</td>
<td>(280, 0.11)</td>
<td></td>
</tr>
<tr>
<td>Seek the help of criminal or mafia groups</td>
<td>1.87</td>
<td>(274, 0.10)</td>
<td></td>
</tr>
</tbody>
</table>

Note: The number of observations and standard errors are in parentheses.

Respondents were asked the following question: *Let’s say that a competitor is trying to gain control of some significant physical asset owned by your firm (e.g., office space or a factory). To defend its assets, how likely would a firm like yours be to do each of the following?*
other firm’s management (5.3), which often is considered to be the first step in resolving a conflict and which topped the list of firms’ preferred strategies in previous survey research (e.g., Hendley et al. 2000; Yakovlev et al. 2004). The high ranking for the use of lawyers out of court is particularly remarkable, providing evidence of the active role lawyers now play in resolving business conflicts. By contrast, the average rankings for the likelihood of turning to a private security firm or criminal protection racket were 2.3 and 1.9, respectively, while the use of corrupt force and delegated law strategies fell somewhere in between. A similar question that examined firms’ preferred strategies for collecting a debt as opposed to resolving an asset conflict produced nearly identical results.

2.4.1 Institutional Abuses

Despite the evidence of demand for institutionalized law, some observers have argued that a large part of the apparent shift to reliance on formal institutions can be attributed to abuses. Volkov (2005), for example, claims that “Among entrepreneurs, the judicial system has begun to be used more and more intensively in recent years.... But this is less related to the rule of law than to the realization of the goals of groups with administrative and financial resources.” Foremost among these abuses is illegal corporate raiding (reiderstvo). While the term is taken from the American usage, it involves far more than buying up a company’s shares in order to change management. Prior to a 2002 reform to the Law on Bankruptcy, one common scheme was to acquire a company’s debt and then utilize legal loopholes to instigate forced bankruptcy, despite the firm’s sound financial health. Raiders would then bribe a judge to appoint a loyal bankruptcy trustee, who would facilitate the seizure of the firm’s assets. Other schemes that continue to be used involve forgery of internal corporate documents or the creation of a second set of documents by paying corrupt government officials. These documents are then used to acquire a majority of voting stock or to create a friendly board of directors. A third tactic relies on civil suits filed with corrupt judges, who then issue a judgment allowing acquisition of assets as a form of compensation. In other cases, raiders pay law enforcement or tax officials to initiate criminal cases against target companies, reducing the market value of the firm they wish to buy or forcing a recalcitrant owner to concede to selling her assets (Firestone 2008; Kabanov et al. 2008; Volkov 2004).

The extent of raiding is notoriously hard to pin down, as raiding is difficult to distinguish from legitimate mergers and acquisitions, or in some cases from basic corporate theft and fraud.\textsuperscript{22} But even the most shocking estimates do not provide grounds to consider the shift toward legal institutions illusory. Volkov (2004, 532) cites figures that as many as a third of bankruptcy cases in 2001 pertained to raiding. Yet, even if this is true, bankruptcy as a

\textsuperscript{22}Approximately 8 percent of the respondents in the survey I conducted reported being the victim of a raid. However, the wide range of raiding tactics makes it difficult to assess the extent to which these raids involved abuses of the judicial system.
whole is a minor fraction of total court usage, as seen in Figure 2.2 above. Although other types of raiding fall into different categories of court cases, the largest class of litigation between firms throughout the 1990s and 2000s has remained the issue of non-payments and unfulfilled contractual obligations, which consistently comprise about 60 to 70 percent of annual inter-enterprise cases; cases pertaining to property disputes are a small fraction of total litigation.  

In summary, raiding and corruption within the judicial system are serious threats in the Russian business world. They are not, however, cause to believe that increased reliance on formal legal institutions is illusory, for they can at best account for a small fraction of the sizeable increase in firms’ use of institutionalized law. In today’s Russia, firms consistently and frequently rely on lawyers, law, and legal institutions.

2.5 Conclusion

Contrary to the widespread perception of lawlessness in Russia, there have been extensive and dynamic changes in firms’ property security strategies. The use of private force has decreased significantly. Criminal groups and private security agencies no longer substitute on a widespread scale for state institutions of adjudication, enforcement, and protection. On the other hand, the role of corrupt force — the appropriation of state resources for the purpose of private protection — continues to play a significant role in the Russian business world. This should not, however, be taken as evidence that law’s role in property security is insignificant. The use of institutionalized law has increased dramatically, and there are signs of an increasing role for delegated law.

To understand the forces driving evolution in property security strategies, it is necessary to analyze institutional formation from the perspective of firms. Interviews indicate that 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 next chapter introduces a framework for analyzing the balance of these benefits and constraints.

23 For sources see footnote 17.
## Appendix 1: Surveys Cited

<table>
<thead>
<tr>
<th>Researcher(s)</th>
<th>Sample</th>
<th>Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Frye (2002)</td>
<td>240 small retail shops in Russia (Ulyanovsk, Moscow, Smolensk) and Poland (Warsaw)</td>
<td>1998</td>
</tr>
<tr>
<td>Hendley et al. (2000, 2001)</td>
<td>328 manufacturing firms of various sizes in the Moscow, Barnaul, Novosibirsk, Ekaterinburg, Voronezh, and Saratov regions</td>
<td>1997</td>
</tr>
<tr>
<td>OPORA (2005, 2006)</td>
<td>80 regions, 50 small businesses from each with the exception of Moscow (300 firms) and St. Petersburg (150 firms)</td>
<td>2004 and 2005</td>
</tr>
<tr>
<td>Radaev (1999)</td>
<td>221 small business from 21 regions</td>
<td>1997</td>
</tr>
<tr>
<td>INDEM (2009)</td>
<td>602 manufacturing and service firms from 16 regions</td>
<td>2008</td>
</tr>
<tr>
<td>Yakovlev et al. (2004)</td>
<td>304 open joint-stock companies in Moscow, Tomsk, and Novgorod regions</td>
<td>2002</td>
</tr>
</tbody>
</table>
Appendix 2: Understanding Russian Caseload Data

In the section in this chapter devoted to formal legal institutions, the caseload data are analyzed after removing cases initiated by the government authorities. These latter cases, while indicative of the overall use of the court system, pertain to administrative details unrelated to firms demand for legal institutions. For example, at the turn of the decade, there was an effort by the tax authorities to purge shell companies from the official registry of firms (these shell companies were often used for tax evasion purposes or simply left idle due to the hassles and expenses of carrying out an official bankruptcy). Likewise, the introduction of laws regulating the use of cash register machines, an effort to restrict firms from hiding revenues from the state, led to a rash of litigation. The extent of such litigation can be extensive. In 2002 the number of cases related to the liquidation of shell companies peaked at 110,000, or nearly 16 percent of total cases in the commercial courts, while in 2001 cases related to cash register regulations peaked at around 37,000, or just under six percent of total cases.

Figure A: Annual Cases Heard in the Russian Commercial Courts

Source: Data are from reports of the Vysshyi arbitrazhnyi sud [High commercial court]. See footnote 17.

Another factor contributing to the growth in caseloads in the early 2000s was the sizeable number of cases pertaining to the seizure of assets belonging to firms that owed tax penalties or payments to extra-budgetary funds, such as the pension fund. Following earlier declarations by the Constitutional Court of the Russian Federation, changes in the Tax Code that came into force in 1999 mandated judicial approval for such seizures, even when the penalties
were undisputed (Hendley 2002, 135; Solomon 2004). While this resulted in a barrage of cases, the caseload data show that the Law “On Mandatory Pension Insurance in the Russian Federation,” which went into effect in 2002 and included a similar provision, had an even bigger effect. The spike in administrative cases beginning in 2003 that is readily visible in Figure A in large part can be accounted for by cases related to the collection of fees, fines, and payments. In 2005 these cases reached their height at 950,000, composing 90 percent of administrative cases and 65 percent of total cases. In response to the massive burden this placed on judges, new rules were introduced allowing uncontested cases of minimal monetary sums to be decided in an extra-judicial administrative forum, leading to a dramatic fall in these cases from 2006 onward, particularly from the side of the tax authorities and extra-budgetary funds.24

Analyses of Russian caseload data that include all administrative cases thus overstate the extent to which the commercial courts are genuinely at the center of business conflicts. Nevertheless, the adjusted data used in Figure 2.2 indicate that reliance on the courts is extensive and continues to grow.

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24See footnote 17 for sources of all caseload statistics presented here.
Chapter 3

Property Security Strategies from the Firm’s Perspective

What accounts for the rising demand for law examined in the previous chapter? This chapter analyzes this question from the perspective of Russia’s firms. It begins with the observation, discussed in Chapter 1, that a comprehensive theory of property rights requires more than an understanding of when rulers seek to create institutions. This “supply” side of institutional formation is important, but no less important is the “demand” side of building institutions. In part, the demand side entails private sector lobbying for institutional reforms. But even beyond lobbying, a theory of property rights requires analysis of the conditions that lead private sector actors to comply with rules of the game once they are created. In other words, we must examine firms’ property security strategies. Understanding how firms select strategies is of utmost importance if we are to understand how to close the gap between formal rules and *de facto* practices that is prevalent throughout the developing world.

Once we shift attention from the creation of institutions to compliance with institutionalized rules, a fundamentally different framework is required. No longer are we in the realm of high-level politics where a few powerful actors shape the contours of institution building. Instead, compliance entails the interaction of numerous, less powerful actors. For most of these actors, institution building is not an explicit goal, even though their collective actions may have a significant impact on the efficacy of institutions. Consequently, while rational choice and historical institutionalist frameworks offer important insights into the demand side of institutional formation, they have significant shortcomings. As discussed in this chapter, in-depth interviews with Russian firms indicate that strategic interaction is only one of many considerations shaping property security strategies. Likewise, historical factors undoubtedly influence property security strategies, yet the development of compliance is not necessarily a path-dependent process.
Instead, this chapter offers a framework inspired by evolutionary game theory, which seeks to understand how ever-changing interactions among numerous actors shape macro outcomes. The past does matter, but it is far from determinative. Strategic interaction also plays a role, but not necessarily because actors are rational or because they are seeking to maximize utility, however defined. Rather, strategies evolve as actors learn and adapt, and the most effective strategies come to dominate the economy. The framework integrates two aspects of the process whereby firms switch from force to law. 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 the shift from force to law involves the interplay of numerous actors, the extent to which reliance on law exists in the overall economy naturally affects the benefit that an individual derives from also relying on law. The vicious and virtuous cycles that result from this interplay among firms produce an evolutionary process that in many ways resembles the tipping point models other scholars have used to analyze revolutions (Kuran 1989), neighborhood segregation (Schelling 1971), and the adoption of national languages (Laitin 1998).

The framework I offer here stands in contrast to the prominent property rights theories based on the New Institutional Economics (e.g., North 1990; North and Weingast 1989) in a fundamental way. Whereas the New Institutional Economics emphasizes the benefits of institutions that protect property rights, the framework here takes full account of the reasons that firms might oppose institutional development. This chapter first offers a critique of the New Institutional Economics (NIE) approaches to the study of property rights through an analysis of the benefits and constraints institutions impose on firms. It then introduces evolutionary game theory and lays out the basis for a simple formal model. Using the model, it then provides analysis of both direct and interactive effects.

3.1 Institutions: Benefits versus Constraints

A theory of property rights that incorporates analysis of compliance must first consider the reasons why firms want — or do not want — to use property security strategies that rely on law instead of force. In other words, we must examine the advantages and disadvantages that institutional development poses from the perspective of firms.

The very definition of institutions presumes constraints: Institutions are “the humanly devised constraints that structure human interaction” (North 1990, 3). Yet the NIE tradition focuses almost solely on the ways in which these constraints benefit society. As North explains in a classic statement of the role of institutions:

The basic services that the state provides are the underlying rules of the game.
CHAPTER 3. FROM THE FIRM’S PERSPECTIVE

...they have two objectives: one...maximizing the rents accruing to the ruler; two...to reduce transaction costs in order to foster maximum output of the society and, therefore, increase tax revenues.... The second objective will result in the provision of a set of public (or semi-public) goods and services designed to lower the cost of specifying, negotiating, and enforcing contracts which underlie economic exchange (North 1981, 24, italics added).

Indeed, one of institutional economic’s fundamental lessons is that the measurement and enforcement costs entailed in transactions are sizable. Institutions that protect property rights and enforce contracts — courts, specialized law enforcement bodies, checks on predatory state bureaucrats — reduce transaction costs, making long term investments lucrative and enabling exchanges that might otherwise be untenable. Growth increases and society benefits.

But even if society as a whole benefits, how does the introduction of new constraints affect specific individuals, firms, or groups? As discussed in Chapter 1, scholars have been quick to recognize that a ruler — or group of elites — may oppose institutional development for fear that it will undermine their appropriation of resources or grip on political power (e.g., Acemoglu and Robinson 2006). However, significantly less attention has been paid to the fact that many firms, even as they benefit from institutions that protect assets and enforce contracts, also chafe under the constraints such institutions impose. The same institutions that protect firms and enable them to conduct business with lower transaction costs also constrain the strategies at a firm’s disposal for acquiring, protecting, and exchanging assets. The conflicting incentives imposed by institutional development are succinctly captured by a Siberian entrepreneur’s response to the question, is it easier or more difficult to do business today than ten years ago: “It is easier — because there are more laws. And it is harder — because there are more laws” (author interview, 28 September 2009, 092809-F52). For instance, institutional development reduces a firm’s security expenses but also makes it riskier to bribe law enforcement officials to turn a blind eye when acquiring a competitor’s assets through illegal means.

During the massive asset-grab incited by the privatization of Soviet enterprises, it is no mystery why actors with a comparative advantage in force would perceive institutional development as an imposition (Áslund 1999; Hellman 1998; Volkov 2002). But the dualistic nature of law as both enabling and constraining involves significantly broader considerations. As discussed in Chapter 2, large swaths of firms in transition and developing countries operate outside the law, relying on private or corrupt force. Yet the existing NIE literature presumes a stark divide between illegitimate actors who do not play by the rules and legitimate actors who act lawfully and thus benefit from the effective constraints on rule breakers. This may be an appropriate assumption in developed economies, but at foundational moments when societies seek to move from a system with widespread private force to a system based on law, the daily practices of the majority of firms make them rule breakers.
There are therefore numerous reasons why constraints of institutional development might outweigh the benefits for certain firms. First, firms with a *comparative advantage* in the use of private or corrupt force might oppose a widespread shift toward reliance on law. Contrary to expectations, it is not only large and powerful firms that benefit in an unlawful environment. Throughout the economy, firms with greater-than-average informal connections — such as the law enforcement protection rackets discussed in Chapter 2 — do not wish to see their comparative advantage eroded by the introduction of the rule of law. Second, even firms without a comparative advantage may see an *absolute advantage* to force over law, especially once they have accumulated experience and resources for using bribery, informal connections, or the application of coercion. For example, in a not uncommon response to government campaigns to root out corrupt bureaucrats, a Moscow small businessmen expressed alarm: “It took me so long to establish my contacts, and I don’t want to lose them” (Mereu 2008).

To firms that for many years have effectively utilized property security strategies that rely on force, it may seem inefficient or even impossible to acquire a similar level of experience and resources dedicated to the use of law.

Even for firms that do not possess a comparative or absolute advantage in force over law, the actual *transition* to a law-bound society may be prohibitively difficult. First, there is a *time consistency dilemma*. Firms may perceive benefits to effective legal institutions in the future, but they must pay the cost of transitioning to lawful practices now. These costs may be prohibitive, especially for smaller companies. They involve educating management and employees about laws, implementing compliance procedures, and, in many cases, changing established business practices. Second, firms face a *coordination dilemma*. The benefits of legal institutions depend vitally on interactions among firms (Hendley 1997, 243). In blunt terms, if some actors adopt legalistic strategies while others continue to use force, then the firm that trades guns for lawyers finds itself not merely in a disadvantageous but also in a downright dangerous position. Firms are well aware of this dilemma. For instance, the owner of a household goods importing company in the Altai Krai explained that he is in favor of the development of law, but only if it applies to all firms. Otherwise, if he follows the law while others do not, the other guy “has an advantage; he gets ahead more quickly” (author interview, 18 September 2009, 091809-F51). As discussed below, this coordination dilemma has important implications for the evolution of demand for law.

### 3.2 Barriers to Change

To many analysts, the fact that private sector actors — whose wealth depends on secure property rights — would oppose institutional development seems puzzling (e.g., Hoff and Stiglitz 2004; Polishchuk and Savvateev 2004; Sonin 2003). Yet once the numerous constraints discussed above are considered, a second puzzle arises: In a society in which the majority of
firms rely on force, how do large-scale shifts in property security strategies occur? Indeed, existing scholarship on demand for institutional development in the post-communist world, particularly studies based on formal models, emphasizes the difficulty in escaping a low-quality institutional trap (Åslund et al. 2001; Guriev and Sonin 2009; Hoff and Stiglitz 2004; Polishchuk and Savvateev 2004; Sonin 2003). Like studies of institutional development in the West, the starting point for many of these analyses is that private sector actors should want institutions that protect property rights; the fact that they do not is thus a puzzle to be explained. For example, Polishchuk and Savvateev (2004) and Sonin (2003) demonstrate that given high levels of economic inequality and weak state institutions, richer and more powerful firms have the incentive to pay for private protection of property while opposing state-provided protection. This environment allows them to guard their own assets while expropriating weaker citizens’ wealth. Meanwhile, Hoff and Stiglitz (2004) focus on how each actor’s expectation that other actors will oppose the rule of law creates further incentives for opposition to law and order. They prove the existence of multiple equilibria and emphasize the reasons why a country like Russia could become stuck in a lawless equilibrium, such as dependence on natural resources and high levels of corruption.

Yet, as discussed in Chapter 2, dramatic evolution in demand for law has taken place in Russia. This evolution has occurred despite the persistence and even exacerbation of the structural barriers often cited in the studies noted above — corruption, inequality, and a weak civil society. This indicates the need for a framework that can account for evolution in a positive direction, without a wholesale shift in socioeconomic factors. Moreover, many of these models focus narrowly on large firms and their strategic interactions with each other or the state (e.g., Hoff and Stiglitz 2008, Guriev and Sonin 2009). Oligarchs represent only one narrow aspect of the complicated story of demand for law in Russia, and a very different picture emerges when the Russian economy is considered in broader perspective. To develop such a framework, it is essential to examine property security strategies from the perspective of the firm.

3.3 From the Firm’s Perspective: Selecting Property Security Strategies

Given the benefits and constraints of institutional development, how do firms decide whether or not to use force or law in their property security strategies? It is tempting to view a firm’s choice of strategies in economic terms. For instance, the firm first decides whether to deal with property security issues in-house, or to “outsource” these issues to specialists. If outsourcing, the firm chooses to “buy” services from a variety of vendors, ranging at one extreme from criminal protection services to another extreme in which firms pay taxes to the state in
CHAPTER 3. FROM THE FIRM'S PERSPECTIVE

exchange for protection and adjudicatory services. Indeed, an influential trend in research on organized crime has been to view rackets as a business, specializing in provision of protection (Gambetta 1996). From this perspective, a firm’s choice depends on the relative effectiveness, cost, timeliness, and risk of various strategies.

Interviews with businesspeople indicate that there is some validity to this approach. Factors such as effectiveness, cost, timeliness, and risk do matter — especially for large firms with the resources and capacity to maximally employ strategic decision making and to actively cultivate informal connections. But for the majority of firms, decisions about property security in many ways differ fundamentally from other business decisions. First, as Volkov (2002, 19-20,175-177) notes, the analogy of a protection service as a business is often misleading. While firms sometimes voluntarily turn to a protector, it is also sometimes the case that a protector forces its services on a firm. Thus, even when genuine protection services are provided (i.e., even when bandity are engaged in more than extortion), the firm is not simply a consumer. Likewise, almost by definition, relationships with the state are coercive; a firm does not choose to purchase services but rather pays mandatory taxes in the expectation of receiving services in return. Second, firms’ choices are limited to the resources at their disposal. The tools of private or corrupt force — access to private physical coercion or assistance from government officials — are not advertised and “sold” in a literal sense. Personal connections are needed. These connections usually are the result of shared educational and career paths or a well-placed relative. Firms that have such connections use them; those lacking such resources simply do not consider these strategies to be part of their portfolio of options.

Third, issues of security can involve the survival of the firm or well-being of management and employees. Placing a dollar value on such decisions is especially difficult, and non-economic considerations, such as trustworthiness, play a significant role. As a Moscow businessmen explained with respect to how he makes choices related to protection services, “You have to be able to trust who you hire. . . . Otherwise you might be inviting a threat in your front door” (author interview, 25 May 2009, 052509-F23). Finally, interviews with directors of private security agencies with nearly two decades of experience resolving business disputes indicate that conflicts — especially the most vicious ones — often are driven not by strategic decision making but rather by ego, desire for revenge, or other emotional factors.

The framework introduced below develops a middle ground between the strategic and non-strategic approaches. Informed by fieldwork interviews, it depicts firms as acting with bounded rationality and with a choice set that for many firms is quite limited. Evolution in demand for law results in part from firms responding to their environment and in part from the institutional and structural pressures affecting the viability of firms. In short, the mechanisms underlying a transition from force to law at the firm level are those which are quite familiar to students of evolutionary game theory.
3.4 Evolutionary Game Theory

Evolutionary game theory was first developed by biologists as a tool for analyzing which animal traits would be most likely to survive natural selection (Maynard Smith and Price 1973). In recent years, economists and game theorists have latched on to evolutionary game theory in the hope that it can provide insights into which equilibrium actors will choose in models with multiple equilibria (Fudenberg 1998; Weibull 1997; Young 2001). In political science, the main application of evolutionary game theory has been to explore whether strategies of cooperation in international relations are likely to evolve over time (e.g., Bendor 1997; Orbell 2004).

The evolutionary game theory approach, rather than the more common non-cooperative game theory approach, is especially applicable for analysis of demand for law. First, in line with the discussion in the preceding section, evolutionary game theory does not require strong assumptions of rationality on the part of actors. Indeed, in early biological applications of evolutionary game theory, rationality assumptions were entirely absent. In such models, animals are predisposed to use a given “strategy,” and those using strategies with superior payoffs, taking into account the strategies used by other animals, are assumed to be more likely to pass their genetic traits on to future generations (Maynard Smith and Price 1973). Economists, meanwhile, have supplemented natural selection mechanisms with a variety of learning mechanisms, including imitation of successful actors, reinforcement of strategies that have proven successful for an actor in the past, and best reply strategies based on observations of past actions by other actors (Young 2001, 27-30). Second, the dynamic framework inherent in evolutionary game theory is an apt tool for study of the demand for law. Rather than seeking to identify a set of strategies that form a best response to each other (i.e., a Nash equilibrium), an approach that draws attention to the stability of institutions, evolutionary game theory begins with a set of assumptions and analyzes what outcomes are likely to emerge, whether these outcomes depend on initial conditions, and how durable an outcome is likely to be.

3.5 Model

This section presents a simple model. The aim is to make the model comprehensible to all readers, regardless of their familiarity with game theory and formal modeling. Thus, the math has been relegated to an appendix at the end of this chapter. The model draws attention to several key characteristics of institutional development: (1) The expected payoffs to property security strategies depend on the interplay of direct effects (i.e., exogenous factors that determine the benefits and costs of a given strategy) and interactive effects (i.e., the extent to which other firms in an economy use a given strategy). (2) Over time, more
effective strategies become predominant, due to mechanisms such as natural selection or adaptive learning. (3) There exists a threshold or tipping point where a society begins to break from a vicious cycle, in which force engenders the use of more force, and moves into a virtuous cycle, in which legal strategies foster the adoption of additional legal strategies. Therefore, relatively small changes can initiate self-reinforcing cycles with large effects.

Consider first a “recurrent” game in which an asset conflict arises between two firms. As opposed to a “repeated” game in which the same set of actors knows that they will be re-playing the initial stage game again in the future, in a recurrent game the conflict reoccurs but the actors change over time. Formally, it is as if two firms are repeatedly drawn randomly from a large population and forced into a conflict. For simplicity, the initial analysis here assumes that all firms are identical. Once the basic characteristics of the analysis are elucidated, this assumption is relaxed and the implications of multiple types of firms are considered.\footnote{Although the focus here is on two firms, the model is equally applicable to a conflict between a firm and a lower-level bureaucrat, such as a tax collector.}

Firms have an option of using a property security strategy based on force (F) or law (L) to resolve the asset conflict, in line with the distinction between protecting property claims and enforcing property rights introduced in Chapter 1.\footnote{For simplicity, the model focuses on two strategies instead of the four introduced in the typology in Chapter 1.} As noted above, the interpretation of strategies in this framework differs from that in non-cooperative game theory, in which players, taking into account other players’ choices, make strategic choices of their own. Instead, two types of dynamic evolutionary processes are considered here: (1) a natural selection dynamic and (2) an adaptive play dynamic.

The natural selection framework represents the case in which strategic choice is non-existent, as in biological models of the evolution of animal traits. Firms rely on strategies to which they are accustomed or to which they are limited by the resources at their disposal; in extreme instances, firms are under the thumb of criminal or government protection rackets. Firms employing strategies that produce above average payoffs, given the strategies employed by other firms in the economy, are more likely to thrive and survive. In the next period, there will thus be more firms utilizing the strategy that produces higher payoffs (see the replicator dynamic in Taylor and Jonker 1978). An alternative interpretation, which produces the same evolutionary process, would be that it is not the entire firm that survives or fails, but rather that within the firm, effective strategies are more likely to be reused and ineffective strategies more likely to be abandoned.

The adaptive play framework pioneered by Young (1993), by contrast, assumes that actors are boundedly rational. They make strategic choices, but with limited information and with the capacity to make mistakes. Interviews with businesspeople and lawyers indicate that in certain situations, an adaptive learning process is an accurate portrayal of Russian firms.
Via business associations, the business press, personal experience, and professional networks, some, but not all, firms are acutely aware of the strategies other firms are employing, and what has worked well in the past. In formal terms, adaptive learning assumes that a firm takes a limited sample of other actors’ past behavior, and then utilizes the strategy that is the best response to the frequency distribution of observed strategies. Thus, strategies that are best responses to strategies that have been used frequently in the past will be used more in the future. Over time, such strategies will come to predominate. As discussed in the appendix, the evolutionary processes generated by the natural selection dynamic and adaptive play dynamic are for the purpose of most analyses identical, despite their different underlying mechanisms.

Both of these evolutionary processes depend on the expected payoffs to a given strategy, which in part depend on the direct effect of exogenous factors. At the most basic level, the outcome of the asset conflict depends on four factors: (1) The relative probability of a firm winning if it uses force, which in turns depends on the resources for private or corrupt force at the firm’s disposal; (2) the relative probability of a firm winning if it uses law, which in turn depends on the legal resources at the firm’s disposal; (3) the relative efficiency of force versus law, measured by the amount of resources redirected from productive uses to resolution of the conflict; and (4) the risk of punishment when force is used, which could range from imprisonment to the loss of investment by those unwilling to work with unsavory partners.

Under the initial assumption that all firms are identical, they have the same resources. Consequently if both firms use the same strategy, they have an equal probability of winning the conflict. If a firm uses law against force however, its probability of winning is less than $\frac{1}{2}$, capturing the idea, discussed above, that in transition countries a firm may suffer if it employs law while other firms employ force.

In addition to exogenous factors, firms’ expected payoffs depend on the proportion of other firms in the economy using each strategy. To analyze this interplay between direct and interactive effects, we will consider three possible scenarios: a weak state, a strong state, and a transition or developing state.

**Weak State:** In weak states, formal state institutions are highly ineffective, making the use of law inefficient as well as reducing the probability that a firm using force will be caught and punished. Formally, this is the case where the payoff to using F is higher regardless of the other firms’ strategies. Consider what happens if an attempt to implement reforms encourages a fraction of firms in the economy to switch from force to law. Even if there is a sizeable shift, such that the majority of firms begin to use L, firms that use F will be relatively more viable. Whether the mechanism is natural selection or adaptive play, in the next time period there will be fewer firms using property security strategies that rely on L. As a result, the probability that a firm using L will face a firm using F — and thus be at a disadvantage — has grown. There will thus be an even greater shift in the proportion of
firms using F relative to L as time proceeds. A *vicious cycle* occurs until nearly all firms are again relying on force.

In the language of evolutionary game theory, F is an *evolutionarily stable strategy*: In an environment where most firms use force, firms using law will soon become non-viable or come to realize that their survival depends on adaptation to a force-based strategy. This situation is depicted in Figure 3.1(a), where the expected payoffs to force are higher than law, regardless of the proportion of firms using L.

**Strong State**: The exact opposite of a weak state, in a strong state formal institutions are highly effective, making the use of law efficient as well as increasing the probability that a firm using force will be caught and punished. Formally, this is the case where the payoff to using L is higher regardless of the other firm’s strategy. In this case, L is the evolutionarily stable strategy. Even if some firms revert to the use of force, they will be at a disadvantage. More firms in the next round will use law, increasing the size of this disadvantage, and initiating a *virtuous cycle*. This situation is depicted in Figure 3.1(b), where the expected payoffs to using law are higher than the expected payoffs to using force, regardless of the proportion of firms using L.

**Transition or Developing State**: The first scenario may be fitting for failed states that have entirely collapsed, and the second scenario may be fitting for the economies of the advanced industrial countries. But in the majority of the world, an accurate description of the state would fall somewhere in between. Formal state institutions are not so ineffective as to be meaningless, but also not so effective as to be determinative of firms’ strategies. In these cases, the coordination effects discussed above become crucially important. A firm using law will be at disadvantage against a firm using force — but the firm using force would receive an even higher payoff if it would match the other firm’s use of law.

Formally, this is a classic assurance or coordination game: When facing an opponent using F, the payoff to also using F is greater than the payoff to using L; when facing an opponent using L, the payoff to also using L is greater than the payoff to using F. In transition or developing states, both L and F are evolutionarily stable strategies and so the proportion of firms using property security strategies based on law — in other words, the level of demand for law — becomes critically important. As more firms use law, the payoff to using law rises, initiating a virtuous cycle; as more firms use force, the payoff to using force rises, initiating a vicious cycle. There will be a *tipping point* at which, given the proportion of firms using law, the expected payoffs to F and L are equal. When an economy is near this tipping point, small changes can lead to either a virtuous or vicious cycle. This situation is depicted in Figure 3.1(c), where the payoffs to L are higher than for F when the proportion of firms using law are above the tipping point, and the opposite holds true when the proportion of firms using law are below this critical threshold.

For developing and transition states, what happens when there is a shift in the exogenous
Figure 3.1: Evolution of Strategies in Different Types of States

(a) Weak State

(b) Strong State

(c) Transition State

Note: The symbol $\lambda^0$ refers to the initial percentage of firms in the economy relying on law; $\lambda^*$ refers to the percentage of firms using law when an economy tips from a vicious to a virtuous cycle. The solid line represents the expected payoff to using L for any given percentage of firms also using L. The dotted line represents the expected payoff to using F for any given percentage of firms using L.
factors that affect expected payoffs? To take an example that is discussed at greater length in Chapter 4, consider what happens when there is an influx of foreign investors who are unwilling to invest in firms with a reputation for using unlawful property security strategies. In effect, the relative cost of using force has risen, reducing the expected payoffs from force regardless of what strategies other firms use. As shown in Figure 3.2, this leads to a leftward shift in the expected value line for F, which in turn results in a lower threshold needed to tip the economy into a virtuous cycle. In this example, prior to the shift in the relative cost of using force, at least 50 percent of firms needed to use law for a virtuous cycle to begin. After the shift, a virtuous cycle results even if only 45 percent of firms use law. Chapter 4 examines various factors that shift the relative costs and benefits of force and law, and thereby help tip the economy toward lawful strategies.

The model is, of course, highly stylized. As examined below, when there are firms of different types, there will not necessarily be a single and clear-cut tipping point. Nevertheless, the model offers insights into how demand for law depends on the interplay of direct effects resulting from exogenous shifts in payoffs and interactive effects that depend on the proportion of firms using each strategy. Before investigating the more complicated version of the model with multiple firm types, the following section first offers empirical support for the coordination mechanism on which the model is based.

### 3.6 Evidence of the Coordination Mechanism

Rarely do scholars directly test the mechanisms underlying formal models, yet the model presented here immediately offers a testable and falsifiable proposition. Recall the logic of the adaptive play mechanism. Firms do not know which strategy an opponent in a conflict
will use. But based on imperfect knowledge of other firms’ previous strategies, a firm forms an expectation of the strategy it is most likely to face should it engage in a conflict. It then chooses the best response to this predicted strategy.

If the coordination game is an accurate depiction of demand for law in transition countries such as Russia, then by the logic of adaptive play, firms that expect to encounter opponents who use law should be more likely to rely on law. Likewise, firms that expect to encounter opponents who use force should be more likely to rely on force. The claim that an assurance or coordination game is an accurate approximation of the evolution of Russian firms’ property security strategies comes directly from the evidence drawn from in-depth interviews, as discussed above. But the survey I conducted offers the opportunity to test this claim further. In the survey, firms were asked the extent to which they agreed with the statement: “The majority of firms with whom I conduct business do their best to follow the law.” Sixty-six percent of respondents agreed with the statement; thirty-three percent did not. For notational clarity, I refer to firms that believe in the lawfulness of other firms as “believers” and to other firms as “non-believers.”

I then reconsidered the data described in Chapter 2 regarding firms’ preferred strategies for dealing with a property dispute (see Table 2.4). Respondents were given a scenario in which another firm seeks to acquire control of some of its assets and asked to rate on a scale of 1 to 7 how likely they would be to use each possible strategy (e.g., go to court, seek help through informal connections with bureaucrats, hire a private security agency, etc.), where 1 means “very unlikely” and 7 means “very likely.” In the regression analyses shown in Tables 3.1 and 3.2, firms’ rankings on a 1 to 7 scale of their likeliness to use a given strategy to resolve an asset conflict are the dependent variable. The independent variable of interest is labeled “others_lawful,” which takes a value of 1 for respondents who are “believers,” and a 0 for firms who are “non-believers.” To account for factors that might be correlated with firms’ preferred strategies and therefore confound analyses, I include control variables for the age of respondent, gender of respondent, presence of state and foreign shareholder (coded as 1 if the state or foreign owner holds more than 10 percent of shares, and 0 otherwise), membership in a business association, firms size (as measured in number of employees), and dummy variables for city and sector.

As the regression analyses in Table 3.1 show, there is indeed evidence that “believers” are more likely to use law and less likely to use force than “non-believers,” in accordance with the predicted interactive effect. For all strategies involving law, the coefficients on the

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3 Respondents could choose to strongly disagree, disagree, neither disagree nor agree, agree, or strongly agree. The analysis here collapses the responses into a binary variable of those who strongly agree or agree versus those who strongly disagree, disagree, and neither disagree nor agree. The results are robust — albeit more difficult to interpret — if I use an ordinal variable on a 1 to 5 scale (where 1 is strongly disagree and 5 is strongly agree) instead of the binary variable.

4 OLS regressions are shown here. Ordered probit regressions produced similar results. All statistically
“others_lawful” variable are statistically significant at standard levels of confidence and positive in sign. They are also substantively significant. On the 1 to 7 scale of likeliness, believer firms on average rank their likeliness to use bureaucrats in an official capacity nearly a full point higher (or 14 percent of the scale’s total range) than non-believer firms. The corresponding figure for believer firms’ use of courts and law enforcement officials in their official capacity is half a point (or 7 percent of the scale’s total range) higher than for non-believer firms. The magnitude of the interactive effect with respect to using a lawyer out of court is smaller, about one-third of a point (or just under 5 percent of the scale’s range), but still positive and statistically significant.

Regression analyses for strategies involving force provide further confirmation of the coordination mechanism, as shown in Table 3.2. Here, the focus is on strategies such as using courts along with informal connections in the judiciary, turning to bureaucrats or law enforcement officials in their unofficial “private” capacity, or using a criminal protection racket. The coefficients on the “others_lawful” variable are all negative as predicted and, for all strategies other than the use of bureaucrats in their private capacity, statistically significant. Believer firms on average rank their likeliness to use these strategies approximately one-half to two-thirds of a point (7 to 9 percent of the scale’s range) lower than non-believer firms. In other words, “believers” are less inclined to use property security strategies based on force than “non-believers.”

Naturally, these results should be interpreted with some caution. First, there may be significant endogeneity concerns related to reverse causation. Are believer firms more likely to use lawful strategies, or are firms that use lawful strategies more likely to be “believers”? Second, firms that overestimate the lawfulness of others may also be more prone to overestimate their own use of lawful strategies and underestimate their use of strategies based on force. These biases could produce spurious correlations. Third, there may be an imperfect correlation between respondents’ reported likeliness of using a strategy and their actual use of the strategy in real-world conflicts. Yet combined with the findings from in-depth interviews, the regression analyses present evidence consistent with the existence of an interactive effect.

significant results in Tables 3.1 and 3.2 remain unchanged if robust standard errors are used.

Similar analyses revealed a negative association between firms’ belief in others’ lawfulness and their rankings of their likeliness to use private security agencies and internal security services to resolve the asset conflict, but these findings were not robust to the full set of control variables. There appears to be no association between beliefs about others’ lawfulness and rankings of strategies involving delegated law, such as business associations or private arbitration.

An alternative would be to use data on firms’ reported use of actual strategies over the past three years as the dependent variable. This approach, however, presents different problems. Firms use property security strategies in response to specific threats and violations of their legal rights. Naturally, firms that have faced different types or degrees of threats use different strategies, and controlling for these differences is nearly impossible. The hypothetical asset dispute and debt scenarios used in the analyses here have the advantage of measuring firms’ preferred strategy in response to the same threat.
Table 3.1: Interactive Effect and Use of Law to Resolve Property Conflicts

<table>
<thead>
<tr>
<th></th>
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<th>Courts (official capacity)</th>
<th>Bureaucrats (official capacity)</th>
<th>Law Enforcement (official capacity)</th>
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<td>4.12 ***</td>
<td>4.52 ***</td>
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<td></td>
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<td>(0.56)</td>
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Standard errors in parentheses
† significant at $p < .10$; *$p < .05$; **$p < .01$; ***$p < .001$
Table 3.2: Interactive Effect and Use of Force to Resolve Property Conflicts

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Standard errors in parentheses

† significant at $p < .10$; *$p < .05$; **$p < .01$; ***$p < .001$
3.7 Extending the Model: Multiple Firm Types and the Balance of Resources

The preceding analyses examined how exogenous shifts in parameters can affect the tipping point of an economy and how such shifts can initiate self-sustaining cycles due to the interactive effects among firms’ property security strategies. To this point, however, the model has relied on the unrealistic assumption that firms are identical. This section relaxes this assumption and examines how such a change affects the evolution of property security strategies.

Substantively, the extension allows for analysis of how the balance of resources needed for the use of force affects an economy’s path of evolution. Some analysts have suggested that Russian firms’ increasing reliance on law has resulted from an equalization of access to informal connections or to the resources needed for coercion. During the early 1990s, only some firms had the protection of criminal protection rackets, corporate security departments, and private security agencies. Firms with greater access to coercive resources profited. But as stronger groups of firms and criminals destroyed or subsumed weaker ones, those that remained were more evenly matched, making violent resolution of conflicts more costly and risky (Volkov 2002). Similarly, as firms shifted from strategies of private force to corrupt force and began devising ways to exploit state institutions to their advantage, they received above market-level returns. Yet as more firms adopted these strategies and developed the necessary political connections, corporate raids began to result in costly stalemates, encouraging a switch away from corruption and force (Volkov 2004).

As an illustrative example of how the balances of resources affects firms’ strategies, consider the Russian business journalist Dimitrii Butrin’s (2003) elucidating analysis of the evolution of illegal corporate raiding:

The growth in business peoples’ awareness about the planning and carrying out of operations for the redistribution of property has led to a situation in which every time the attacking side presents a court document, the defending side presents their own court document. The raider then turns to his connections in the government — only to find out that his opponent has his own connections. After all, administrative resources are bought and sold at a reasonable price. In such a manner, in response to every step taken by those trying to seize assets, the owners of the assets respond in kind. Their opponents are forced to increase their investment in “buying” government officials and carrying out PR campaigns, and this quickly leads to a situation in which the cost of the raid is equivalent to the value of the assets themselves. . . . And what next? Next the two sides enter into negotiations. And then they realize, it would have been cheaper to have done so at the outset, without so many unnecessary expenditures.
Such analyses, however, raise numerous questions. If the strong devour the weak, leading to consolidation of resources, then it would appear that a transformation of property security strategies and the development of formal state institutions is a natural and inevitable process. This contrasts with the experience of numerous developing countries in which reliance on private and corrupt force languished for extended periods of time. Indeed, as discussed above, many analysts in the late 1990s expected Russia to remain stuck in a low-quality institutional equilibrium.

In this section I compare the evolutionary dynamics of property security strategies when firms have unequal access to resources needed for the use of force with the evolutionary dynamics when they have equal access, as in the base model analyzed above. In the extended model, there are now two sub-populations of firms, which for simplicity I label “weak” and “strong.” The analysis demonstrates that equalization of resources can contribute to increased reliance on law, but that this is only one of four possible evolutionary paths. In fact, under certain conditions, equalization of resources can make reliance on law less likely.

First, reconsider the expected payoffs to a given strategy of force (F) or law (L). As discussed above, these payoffs depend in part on four exogenous factors that influence the outcome of a conflict: (1) The relative probability of a firm’s winning if it uses force, which in turns depends on the resources for private or corrupt force at the firm’s disposal; (2) the relative probability of a firm’s winning if it uses law, which in turn depends on the legal resources at the firm’s disposal; (3) the relative efficiency of force versus law, measured by the amount of resources redirected from productive uses to resolution of the conflict; and (4) the risk of punishment when force is used.

In the base model, where all firms were identical, whenever two firms entered a conflict and used the same strategy, they had an equal probability of winning. With unequal resources, this is no longer true when both firms use force. Instead, “strong” firms win the conflict with a probability greater than \( \frac{1}{2} \) and “weak” firms win the conflict with a probability less than \( \frac{1}{2} \). As before, when both firms use law, they have an equal chance of winning, and when either type of firm uses force against law, it prevails with a probability greater than \( \frac{1}{2} \). In short, strong firms benefit in an environment where force is widespread while weak firms suffer.

As before, the evolution of firms’ strategies depends not only on the exogenous factors that affect payoffs but also on the proportion of firms using each strategy. But whereas in the base model, there were two groups of firms (those using F and those using L), there now are four groups: strong firms using F, strong firms using L, weak firms using F, and weak firms using L. The dynamic processes resulting from the natural selection and adaptive play mechanisms discussed above continue to drive the evolution of strategies, but the evolutionary dynamics are now more complex. In the base model, there is an evolution over time among all firms toward the use of the strategy that results in, given other firms’ strategies, greater than average payoffs. Consequently, there is a unique tipping point at which the proportion of firms using L becomes large enough to initiate a virtuous cycle.
In the extended model, by contrast, strong and weak firms have different payoffs, and thus there are two dynamic processes simultaneously in motion. Among strong firms, there is an evolution toward the use of the strategy that produces higher payoffs for strong firms. Among weak firms, there is an evolution toward the use of the strategy that produces higher payoffs for weak firms. Consequently, there will be different tipping points for each sub-population. In the base model, when both firms use force, they have an equal probability of winning a conflict. In the extended model, weak firms have a lower probability of winning a conflict. Their tipping point is therefore lower than in the base model — all else equal, the proportion of firms in the overall population using law needed to initiate a virtuous cycle among weak firms is smaller than the proportion needed to induce a virtuous cycle when firms are identical. On the other hand, strong firms have a higher probability of winning a conflict when they use force. Their tipping point is therefore higher than in the base model — all else equal, the proportion of firms in the overall population using law needed to initiate a virtuous cycle among strong firms is larger than the proportion needed to induce a virtuous cycle when firms are identical.

These dynamics raise the possibility that the strategies of strong and weak firms will evolve along countervailing paths: the former toward the use of force and the latter toward the use of law. Moreover, in addition to the exogenous factors noted above, the tipping points will be affected by a new parameter: the fraction of strong and weak firms in the economy. In this extended model, there are four possible evolutionary paths, and the effect of equal or unequal access to resources for strategies based on force differs for each path:

1. Convergence toward Law: If parameters are such that the payoffs to law are greater than the payoffs to force even for strong firms, then the payoffs to law will also be greater than the payoffs to force for weak firms. Strategies will evolve toward law for both sub-populations. With these parameter values, the economy with identical firms will also converge toward law. Thus, the outcome of the unequal and equal resource cases is the same, although the pace of convergence may differ.

2. Convergence toward Force: If parameters are such that the payoffs to force are greater than the payoffs to law even for weak firms, then the payoffs to force will also be greater than the payoffs to law for strong firms. Strategies will evolve toward force for both sub-populations. With these parameter values, the economy with identical firms will also converge toward force. Thus, the outcome of the unequal and equal resource cases is the same, although the pace of convergence may differ.

In these two scenarios, equalization of access to resources for the use of force is not a driving

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7 The tipping point for strong firms is not unique, as discussed in the appendix to this chapter.

8 This follows from the fact noted above that the tipping point in the equal resources case will be (1) greater than for weak firms in the unequal resources case and (2) smaller than for strong firms in the unequal resources case.
force behind the transformation of property security strategies. Unequal access potentially plays an important role, however, when parameters are such that strong firms’ payoffs to force are greater than to law, while weak firms’ payoffs to law are greater than to force. In this case, divergence occurs: The proportion of strong firms using law shrinks while the proportion of weak firms using law grows. This divergence will be stable if: (1) the payoffs for strong firms using law remain below the payoffs to force as the proportion of strong firms using L goes to zero and (2) the payoffs for weak firms using law remain above the payoffs to force as the proportion of weak firms using L goes to 1.

If these conditions do not hold, then the divergence will be temporary. The proportion of strong firms using law will first shrink, but then as the proportion of weak firms using law grows, the payoff for strong firms from the use of force decreases and eventually falls below the payoff from law. After temporary divergence, both sub-populations tend toward lawful strategies. Whether or not divergence is temporary depends on the fraction of strong and weak firms. The greater the fraction of weak firms, whose strategies under divergence evolve toward law, the more likely that divergence will be temporary and that weak firms will eventually pull strong firms toward law. This occurs for two reasons. First, the fewer weak firms using force, the less strong firms benefit from their relative advantage in coercion. Second, the coordination mechanism introduced in the base model continues to play a role, and as the overall level of firms using law increases, the payoffs of using law relative to force rise for firms of all types.

Divergence leads to two additional evolutionary paths:

3. Unequal Resources Undermine Virtuous Cycle: Consider parameters such that the payoffs to using law are lower than the payoffs to force for strong firms; the payoffs to using law are higher than the payoffs to force for weak firms; and when firms have equal resources, the payoffs to using law are higher than to force. Then with equal resources, a virtuous cycle toward law happens with certainty. With unequal resources, a virtuous cycle will occur only if the divergence between strong and weak firms is temporary. That is, only if there is a sufficient proportion of weak firms will evolution of the economy toward law occur. Otherwise, the economy converges to a stable environment in which strong firms use force and weak firms use law.

4. Unequal Resources Provide Opportunity for Virtuous Cycle: Consider parameters such that the payoffs to using law are lower than the payoffs to force for strong firms; the payoffs to using law are higher than the payoffs to force for weak firms; and when firms have equal resources, the payoffs to using law are lower than to force. Then with equal resources, a vicious cycle toward force happens with certainty. With unequal resources, by contrast, it is possible that a virtuous cycle will occur, given a sufficient proportion of weak firms. If the divergence among strong and weak firms is temporary, then the rising number of weak firms using law eventually shifts payoffs until it is beneficial for strong firms to use law as well.
This analysis thus indicates that the effect of the equalization of resources for force is complex and multifaceted. It depends on: (1) The relative probability of a firm winning if it uses force; (2) the relative probability of a firm winning if it uses law; (3) the relative efficiency of force versus law; (4) the risk of punishment when force is used; and (5) the proportion of strong and weak firms in an economy. The fact that equalization of resources has played a positive role in Russia suggests a specific set of parameter values. As Chapter 4 will elucidate, these parameter values, in turn, depend on a variety of socioeconomic, political, and institutional factors, which ultimately account for why a positive evolutionary process occurred as resources needed for force became more equal.

3.8 Conclusion

Whereas most studies on property rights focus on institutional creation, understanding the transformation of property security strategies that has occurred in Russia requires attention to firms’ behavior — specifically, their incentives to use, circumvent, or subvert formal institutions. Such analysis necessitates a framework that moves beyond high-level politics and examines the interaction of numerous, less powerful actors. The framework offered here, inspired by evolutionary game theory, demonstrates that property security strategies evolve in response to the interplay of shifts in the exogenous factors that shape the relative costs and benefits of compliance (i.e., direct effects) and the extent to which other firms rely on law (i.e., interactive effects). The next chapter examines the change over time in the incentive structures shaping firms’ use of force and law.
CHAPTER 3. FROM THE FIRM’S PERSPECTIVE

Appendix: Formal Analysis of an Evolutionary Game

Model Setup

Consider a recurrent game $G$ in which conflicts arise between two firms drawn randomly from a large population of firms. To begin with, we assume that all firms are identical; this assumption is relaxed below. Each firm $i$ has a pure strategy profile $s_i = \{L, F\}$, where $L$ represents legal strategies and $F$ represents non-legal strategies.

The assets in dispute are worth a value $V$. When a conflict occurs between two firms using $F$ strategies, the probability of Firm 1 winning is $r$. Use of $F$ strategies involves a risk that illegal activity will be detected with probability $q$ and punished with a fine $P$. When a conflict occurs between a firm using a $F$ strategy and a firm using a $L$ strategy, the $F$ strategy wins with certainty. This captures the idea that a firm that utilizes legal strategies suffers in an environment in which other firms employ unlawful practices. Finally, when a conflict arises between two firms using $L$ strategies, Firm 1 wins with probability $p$. The winner of such a conflict receives $\alpha V$, where $\alpha$ is a measure of the effectiveness of formal legal institutions. When $\alpha > 1$, formal institutions are relatively more effective than illegal dispute resolution mechanisms. When $\alpha < 1$, the opposite is true.

Payoffs are depicted in Figure A. Note that given the assumption that firms are identical, they have an equal chance of winning a conflict, that is, $r = p = \frac{1}{2}$. Payoffs in this case are symmetric. Throughout most of the analysis that follows, we will focus on coordination game payoffs such that $F$ is a best response to $F$ and $L$ is a best response to $L$ (formally, $rV - qP > 0$ and $\alpha pV > V - qP$).

At the outset of analysis, a fraction $\lambda$ of firms use legal strategies and a fraction $1 - \lambda$ of firms use non-legal strategies. As noted above, the interpretation of strategies in this framework differs from that in non-cooperative game theory, in which players, taking into account other players’ choices, make strategic choices of their own. Two types of dynamic processes are considered here: (1) a natural selection dynamic and (2) an adaptive play dynamic.

The natural selection framework represents the case in which strategic choice is non-existent. Firms employing strategies that produce above average payoffs, given the strategies employed by other firms in the economy, are more likely to survive. In the next period, there will thus be more more firms utilizing the strategy that produces higher payoffs. Formally, let $W(F; \lambda)$ be the expected value of using a strategy $F$ in a randomly paired conflict with another firm in the economy, given the distribution of firms using each strategy; $W(L; \lambda)$ be

---

9 A recurrent game differs from a repeated game in that players in a repeated game remain fixed over time. In a recurrent game, the game is played repeatedly but between different players in each time period.

10 This assumption simplifies the analysis and does not qualitatively change the results.
the expected value of using a strategy L in a randomly paired conflict, given the distribution of firms using each strategy; and \( \bar{W} \) be the average economy-wide payoff of firms engaging in conflicts. Then, given symmetric payoffs \( (r = p = \frac{1}{2}) \):

\[
W(F; \lambda) = (1 - \lambda) \left( \frac{V}{2} - qP \right) + \lambda (V - qP) \quad (3.1)
\]

\[
W(L; \lambda) = \lambda \frac{V}{2} \quad (3.2)
\]

\[
\bar{W} = (1 - \lambda) W(F; \lambda) + \lambda W(L; \lambda) \quad (3.3)
\]

In the natural selection framework, reliance on a given strategy increases or decreases over time in accordance with the replicator dynamic (Jonker and Taylor 1978). This framework approximates the growth rate in the number of firms using a strategy with the size of the strategy's expected payoff in the preceding period. Thus, if \( n_s^t \) is the number of firms using a strategy \( s \) at time \( t \), where \( s \in \{L, F\} \), then \( n_s^{t+1} = W^t(s; \lambda^t)n_s^t + n_s^t = n_s^t[W^t(s; \lambda^t) + 1] \). To determine the change in the proportion of firms relying on a given strategy, note that \( \lambda_s^t = \frac{n_s^t}{N^t} \), where \( N^t \) is the total number of firms at time \( t \). Then with some algebraic manipulation, we can show that \( \lambda_s^{t+1} = \lambda_s^t \left[ \frac{W^t(s; \lambda^t) + 1}{W^t + 1} \right] \)\(^{11} \). Define \( \Delta \lambda_s^{t+1} \equiv \lambda_s^{t+1} - \lambda_s^t \). Then the replicator dynamic can be written as follows:

\[
\Delta \lambda_s^{t+1} = \lambda_s^t \left[ \frac{W^t(s; \lambda^t) - \bar{W}^t}{\bar{W}^t + 1} \right] \quad (3.4)
\]

\(^{11}\lambda_s^{t+1} = \frac{n_s^{t+1}}{N^{t+1}} = \frac{W^t(s; \lambda^t)n_s^t + n_s^t}{W^t + n_s^t} = \frac{n_s^t[W^t(s; \lambda^t) + 1]}{N^t[\bar{W} + 1]} = \lambda_s^t \left[ \frac{W^t(s; \lambda^t) + 1}{\bar{W} + 1} \right]. \)
The replicator dynamic formalizes the idea, introduced above, that the change in the share of firms using a given strategy from time $t$ to time $t+1$ depends on the difference between the expected payoff of a given strategy and the average payoff of firms facing conflicts, weighted by the share of firms using the given strategy. Strategies with above average payoffs become more prominent over time; strategies with below average payoffs become less prominent.

The adaptive play framework pioneered by Young (1993), by contrast, assumes that actors are boundedly rational. Concretely, adaptive learning assumes that a firm takes a limited sample of other actors’ past behavior, and then utilizes the strategy that is the best response to the frequency distribution of observed strategies. Thus, strategies that are best responses to strategies that have been used frequently in the past will be used more in the future. Formally, let $s^t_i \in \{L, F\}$ be the strategy chosen by firm $i$ at time $t$. For simplicity, we continue to consider the case where all firms are identical and two firms are drawn at random to play the game described above. The record of play at time $t$ is thus $s^t = (s^t_1, s^t_2)$. The state of the system, $h^t$, is the sequence of the last $m$ records of play, where $m$ represents the number of historical records that actors take into account: $h^t = (s^{t-m+1}, ..., s^t)$. An actor takes a sample of size $n$ from the set of all strategies used by all firms that previously have played the game over the last $m$ rounds, producing sample distributions (i.e., random variables) $\hat{\lambda}$ and $1 - \hat{\lambda}$ of firms’ relative use of legal and non-legal strategies. The firm then chooses the strategy that is the best response given this sample distribution, namely, strategy $s$ such that $W(s; \hat{\lambda}) \geq W(s'; \hat{\lambda})$ for all $s' \in \{L, F\}$.

The adaptive play dynamic process thus evolves as follows. Define a best reply function $B^*_s(\hat{\lambda}) = 1$ if and only if strategy $s$ is a best response given the sample distribution $\hat{\lambda}$ and 0 otherwise. Then the fraction of firms that will be using strategy $s$ at time $t + 1$ is:

$$\lambda^{t+1}_s = \frac{B^*_s(\hat{\lambda}) + n^t_s}{N^t + 1}$$

(3.5)

In words, the adaptive play selection dynamic states that strategies that are best replies given a firm’s estimate of the strategies other firms have been using will be used more frequently in the future. Over time, such strategies will come to predominate.\(^\text{12}\)

### 3.8.1 Evolutionary Stable Strategies

The seminal solution concept for evolutionary game theory is the concept of an evolutionary stable strategy (ESS) (Maynard Smith and Price 1973). Consider an economy in which non-

\(^{12}\)The final element of adaptive play is that firms with some small probability, $\epsilon$, do not choose the best response given the sample distribution. This error rate can be interpreted either as exogenous stochastic shocks that influence firms’ behavior or as indication of human fallibility.
legal strategies are prevalent. A small proportion of firms \( \epsilon > 0 \) willing to use legal strategies enter the economy. In such an economy, will firms using legal strategies thrive and multiply, or will they be squeezed out leading back to an economy dominated by non-legal strategies? Analysis of evolutionary stable strategies examines the robustness of a given strategy once it has come to predominate in a population. If \( F \) is an evolutionary stable strategy (ESS), then even with the introduction of firms using \( L \), firms relying on \( F \) will continue to receive above average payoffs and over time the proportion of firms relying on \( L \) will shrink back toward zero. Formally, an ESS is defined as follows:

**Definition 1:** A strategy \( s \) is an evolutionary stable strategy if for all \( s' \neq s \) there exists some \( \epsilon \in (0, 1) \) such that for all \( \epsilon < \tilde{\epsilon} \), \( W[s, \epsilon s' + (1 - \epsilon)s] > W[s', \epsilon s' + (1 - \epsilon)s] \).

Here, the notation \( W(s, s') \) represents the payoff of using strategy \( s \) when one’s opponent uses strategy \( s' \). To provide the intuition behind an ESS, it is helpful to note that Definition 1 is equivalent to saying that a strategy \( s \) is an evolutionary stable strategy if for all \( s' \neq s \), (i) \( W(s, s) \geq W(s', s) \) or (ii) if \( W(s, s) = W(s', s) \), then \( W(s, s') > W(s', s') \). In words, an ESS fares at least as well against itself as does an alternative strategy; if the ESS fares equally well against itself as does the alternative strategy, then the ESS fares strictly better against the alternative strategy than the alternative strategy does against itself.

It is straightforward to verify that if either strategy \( L \) or \( F \) is weakly dominated, it will not be an ESS. An economy in which the payoff to using \( F \) is (weakly) greater than the payoff to using \( L \), regardless of other firms’ strategies, will naturally be locked in a state in which non-legal strategies predominate, and vice versa. The case of the coordination game presented above, however, offers the opportunity for richer analysis with direct application to post-communist Russia and similar economies. In such a coordination game, it is both true that \( W(F, F) \geq W(L, F) \) and that \( W(L, L) \geq W(F, L) \), which leads to the following proposition:

**Proposition 1:** In the \( 2 \times 2 \) game \( G \) with payoffs \( \frac{V}{2} - qP > 0 \) and \( \frac{\alpha V}{2} > V - qP \), both \( F \) and \( L \) are evolutionary stable strategies.

**Proof.** The proof follows directly from Definition 1. \( \square \)

The immediate implication is that initial conditions matter. In an economy with the payoff structure of game \( G \), either lawful or unlawful strategies persist once they come to dominate. Here, the ESS concept clearly has much in common with the two pure Nash equilibria in the coordination game: \( (F, F) \) and \( (L, L) \). The ESS concept provides a starting point for analysis, but like the Nash equilibrium solution concept it focuses on the robustness of an

\[ \text{In general, all ESS are NE, but the converse does not hold (see Weibull 1995, 36-37).} \]
outcome once it is reached while offering minimal insight into why a society tends toward one outcome or another. Also, the notion of an ESS assumes that a small share of the population uses the alternative strategy, but in the case of multiple ESS it is imprecise about how small this share must be for a strategy to be evolutionarily stable. Finally, the concept of an ESS is relatively static. The solution concepts analyzed below make the evolutionary dynamics explicit rather than leaving them in the background.

Stable States and the Tipping Point toward Demand for Law

When two outcomes of an evolutionary process are possible, what factors tilt an economy in one direction or another? At what threshold does an economy develop tendencies toward reliance on lawful versus unlawful strategies? To further develop a dynamic framework for examination of these questions, it is first necessary to offer additional definitions. Let \( Z \) be the set of possible states in a dynamic system. A discrete-time dynamical process is a function \( \zeta(t, z) \) defined for all times \( t \) and all \( z \in Z \) such that if the process is in state \( z \) at time \( t \), then it is in state \( z' = \zeta(t, z) \) at time \( t + 1 \). The solution path of such a process, with initial point \( z^0 \), is given by \( \{z^0, z^1 = \zeta(0, z^0), z^2 = \zeta(1, z^1), \ldots\} \). The replicator dynamic and adaptive play selection dynamic introduced above are examples of dynamical processes.

Consider a population state in which a fraction \( \lambda^0 \) of firms initially relies on legal strategies. The solution path is given by the proportion of firms using legal strategies in each successive period. We can say that a state in which all firms use legal strategies is Lyapunov stable if once the solution path gets sufficiently close to such a state, there is not backsliding towards a population state in which non-legal strategies predominate. We can say that such a state is asymptotically stable if it is Lyapunov stable and if there exists a neighborhood \( B^* \) such that if a solution path enters \( B^* \), then it converges to \( z \).

Definition 2: A state \( z \) is Lyapunov stable if every open neighborhood \( B \) of \( z \) contains an open neighborhood \( B^0 \) of \( z \) such that any solution path that enters \( B^0 \) stays in \( B \) from then on. A state \( z \) is asymptotically stable if it is Lyapunov stable and if there exists a neighborhood \( B^* \) such that if a solution path enters \( B^* \), then it converges to \( z \).

Well established results demonstrate that in a 2 x 2 coordination game, both strict Nash equilibria are asymptotically stable in the natural selection framework (Weibull 1997, 74-76). Although we do not show this formally, the results also hold for the adaptive play framework when the error rate is zero (Young 1998, ch. 3). The intuition for why this must be true is detailed below. For the purpose of our analysis, the central question is at what threshold an economy will tend toward a stable state in which legal rather than non-legal strategies dominate.
CHAPTER 3. FROM THE FIRM’S PERSPECTIVE 75

Proposition 2: Consider the 2 x 2 recurrent game $G$ with payoffs $\frac{V}{2} - qP > 0$ and $\frac{\alpha V}{2} > V - qP$, and define the dynamic process $\zeta(t, \lambda)$ as the replicator dynamic in equation (3.4). Then:

(i) The states $\lambda = 0$ and $\lambda = 1$ are both asymptotically stable.

(ii) There exists a saddle point $\lambda^* = \frac{\frac{V}{2} - qP}{\frac{\alpha V}{2} - (\alpha - 1)} \in (0, 1)$. For $\lambda^0 > \lambda^*$ the dynamic process converges to $\lambda = 1$. For $\lambda^0 < \lambda^*$ the dynamic process converges to $\lambda = 0$.

Proof. (i) In the coordination game $G$, it is straightforward to verify that both (F, F) and (L, L) are strict Nash equilibria. Strict Nash equilibria are asymptotically stable in payoff monotonic selection dynamics (i.e., dynamics in which the growth rates of strategies are strictly monotonic in their expected payoffs), such as in the case of replicator dynamics (Hofbauer 1988). (ii) To find $\lambda^*$, set equation (3.1) equal to (3.2) and solve for $\lambda$. In population state $\lambda^*$ the replicator dynamic (3.4) is equal to zero. This is a stationary state in which reliance on each strategy neither grows or shrinks. However, a slight perturbation in either direction and the stationary state is permanently disrupted. While $\lambda^*$ is the mixed strategy NE for the coordination game $G$ given symmetric payoffs, it can be verified that it is not a mixed strategy ESS. For 2 x 2 symmetric coordination games, a population state is asymptotically stable in the replication dynamics if and only if the corresponding mixed strategy is an ESS (see Weibull, 1995, 40-41, 74-75). If $\lambda^*$ is not an asymptotically stable state, then the system is tending to either $\lambda = 0$ or $\lambda = 1$. By the replicator dynamic in equation (3.4), when $\lambda^0 > \lambda^*$, $\lambda$ is growing and when $\lambda^0 < \lambda^*$, $\lambda$ is shrinking. \qed

Intuitively, recall that in the natural selection framework, strategies that earn above average expected payoffs become more prominent in future time periods. Given the nature of a coordination game, a legal strategy earns a higher expected payoff when one’s opponent is likely to also use a legal strategy, and vice versa. Once the expected payoff to using legal strategies is higher than the expected payoff to using non-legal strategies, conditional on the strategies being used by other firms, more firms in the following time period will use legal strategies. This in turn makes it still more profitable to use legal strategies, initiating a virtuous cycle that results in all firms relying on legal strategies. Of course, if enough firms use non-legal strategies, the opposite can occur, and the economy can descend into a vicious cycle. A similar process takes place in the adaptive play framework. The more that firms use legal strategies, the more likely other firms are to observe such strategies. Since L is a best reply to L, the larger the sample distribution $\hat{\lambda}$, the more likely are firms to choose legal strategies — which in turn increases the probability that $\hat{\lambda}$ will be large in future periods.

The threshold $\lambda^*$ represents a tipping point in the economy. It is the proportion of firms using legal strategies such that expected payoffs to legal strategies and expected payoffs to non-legal strategies are equal. If transformations in the economy occur that shift $\lambda^*$ downward,
then an economy that is reliant on unlawful strategies may tilt toward a virtuous cycle. The formula for $\lambda^*$ provides insights into what some of these factors might be:

$$
\lambda^* = \frac{V}{2} - qP
$$

(3.6)

It is clear that as the probability ($q$) or severity ($P$) of punishment for illegal behavior rises, $\lambda^*$ decreases. That is, fewer firms need to use legal strategies to initiate a virtuous cycle. A improvement in state capacity ($\alpha$) has a similar effect.

**Asymmetric Firm Characteristics**

The preceding analysis demonstrates how exogenous shifts in parameters can affect the tipping point of an economy. The model can also be extended to consider the effects of firm-level factors on a system’s tipping point.

In this section I compare the evolutionary dynamics when firms have equal access to resources for non-legal strategies with the evolutionary dynamics when firms have unequal access. In other words, there are now two sub-populations of firms, which I label weak (W) and strong (S). The analysis demonstrates that equalization of resources can increase the likelihood that demand for law will increase, but that this outcome depends on socioeconomic and institutional conditions, as well as on the fraction of strong-versus-weak firms.

When a strong firm is matched with a weak firm, the former has a higher probability of winning using non-legal strategies than does its opponent. That is, $r_S > \frac{1}{2}$ and $r_W = 1 - r_S < \frac{1}{2}$. When two strong firms or two weak firms using non-legal strategies have a dispute, they continue to have equal probability of winning. Likewise, when a firm using non-legal strategies meets a firm using legal strategies, it wins with certainty, regardless of each firm’s type. Finally, when both firms settle a dispute through legal strategies, they again have an equal probability of winning. A fraction $\psi$ of all firms are strong and $1 - \psi$ are weak. Among strong firms, a proportion $\lambda^L_S$ rely on legal strategies, and a proportion $\lambda^F_S = 1 - \lambda^L_S$ rely on non-legal strategies. Similarly, among weak firms, a proportion $\lambda^L_W$ rely on legal strategies, and a proportion $\lambda^F_W = 1 - \lambda^L_W$ rely on non-legal strategies. The expected payoffs introduced in Equations 3.1-3.3 can thus be rewritten as:
\[ W_S(F) = [\lambda^L_S \psi + \lambda^L_W (1 - \psi)](V - qP) + \lambda^S_S \psi \left( \frac{V}{2} - qP \right) + \lambda^F_W (1 - \psi)(r_S V - qP) \]
\[ W_W(F) = [\lambda^L_S \psi + \lambda^L_W (1 - \psi)](V - qP) + \lambda^S_W \psi \left( r_W V - qP \right) + \lambda^F_W (1 - \psi)\left( \frac{V}{2} - qP \right) \]
\[ W_S(L) = W_W(L) = [\lambda^L_S \psi + \lambda^L_W (1 - \psi)] \frac{\alpha V}{2} \]
\[ W_S = \lambda^F_S W_S(F) + \lambda^L_S W_S(L) \]
\[ W_W = \lambda^F_W W_W(F) + \lambda^L_W W_W(L) \]

Note that for a fixed \( V, q, P, \alpha, r_S, \text{ and } \psi \), there is not a unique proportion of firms \( \lambda^L \) using legal strategies at which a tipping point exists (i.e., at which \( W_S(F) = W_S(L) \)). Instead there is a vector \( \lambda^* = (\lambda^*_{S,L}, \lambda^*_{W,L}) \) for which the expected payoffs to using L and F are equal. Strong firms receive a higher expected payoff to using L when there are fewer weak F firms, all else equal. However, a low proportion of weak F firms could be due to either a low proportion of weak firms (high \( \psi \)) or to a low proportion of F firms among a relatively larger proportion of weak firms (low \( \lambda^F_W \) and low \( \psi \)). Thus, if there are fewer weak F firms, all else equal, the overall proportion of firms relying on L needed to push the strong firm sub-population into a virtuous cycle can be lower. In other words, with fewer sources of easy prey, strong firms benefit less from using F strategies.

The opposite is true for weak firms. For a fixed \( V, q, P, \alpha, r_S, \text{ and } \psi \), the higher the proportion of strong F firms, the lower the overall level of firms relying on L required to push the weak firm sub-population into a virtuous cycle. In other words, when there are a large number of strong firms using illicit practices, the benefit for weaker firms of seeking the protection of the law rises.

Given that strong and weak firms evolve separately, there are two replicator dynamics:

\[ \Delta \lambda^t_{S} = \lambda^t_S \left[ \frac{W_S^t(L; \psi^t, \lambda^t) - W_S^t}{W_S^t + 1} \right] \]  
\[ (3.7) \]
\[ \Delta \lambda^t_{W} = \lambda^t_W \left[ \frac{W_W^t(L; \psi^t, \lambda^t) - W_W^t}{W_W^t + 1} \right] \]  
\[ (3.8) \]

Define \( \lambda^* \) as the threshold proportion of firms using L needed to initiate a virtuous cycle when all firms are identical, and consider a fixed set of socioeconomic and institutional conditions (as defined by the parameters \( q, P, V, r, \text{ and } \psi \)). There are now four evolutionary possibilities, and the equality or inequality of resources matters only under certain parameters:
1. **Full convergence to L**: When the initial proportion of strong and weak firms using legal strategies, \( \lambda_0 = (\lambda_{0}^{S,L}, \lambda_{0}^{W,L}) \), is such that the payoffs to using legal strategies are better than average payoffs *even for strong firms*, then it can be shown that the payoffs to using legal strategies are also better than average payoffs for weak firms. Consequently, demand for law rises. This is true regardless of equality of access to resources, because under these conditions the threshold proportion of firms using L is met under both the equal \( (r_S = \frac{1}{2}) \) and unequal \( (r_S > \frac{1}{2}) \) scenarios (i.e., \( \lambda_{W,L}^{*}(\lambda_{S,L}) < \lambda^{*} < \lambda_{S,L}^{*}(\lambda_{W,L}) < \lambda_0 \)).

2. **Full convergence to F**: When the initial proportion of strong and weak firms using L is such that the payoffs to using legal strategies are worse than average payoffs *even for weak firms*, then it can be shown that the payoffs to using legal strategies are also worse than average payoffs for strong firms. Consequently, a vicious cycle begins away from lawful practices. This is true regardless of equality of access to resources, because under these conditions neither in the equal \( (r_S = \frac{1}{2}) \) nor in the unequal \( (r_S > \frac{1}{2}) \) scenario is the threshold proportion of firms using L met (i.e., \( \lambda_0 < \lambda_{W,L}^{*}(\lambda_{S,L}) < \lambda^{*} < \lambda_{S,L}^{*}(\lambda_{W,L}) \)).

Inequality of resources matters, however, when socioeconomic and institutional conditions create incentives whereby strong firms’ payoffs to legal strategies are below average and weak firms’ payoffs to legal strategies are above average. When the initial proportion of firms using L is such that the payoffs to using legal strategies are worse than average payoffs for strong firms but better than average for weak firms, divergence occurs: The proportion of strong firms using L shrinks (i.e., the replicator equation (3.7) is negative) while the proportion of weak firms L grows (i.e., the replicator equation (3.8) is positive). This divergence will be stable if the payoffs to strong firms for using L remain below average and payoffs to weak firms for using L remain above average (that is, \( W_S(F) > W_S(L) \) and \( W_W(L) > W_W(F) \)) as the proportion of strong firms using L goes to zero and the proportion of weak firms using L goes to 1. If these conditions do not hold, then the divergence will be temporary. The proportion of strong firms using L will first shrink, but then as the proportion of weak firms using L grows, the payoff for strong firms from F decrease and eventually fall below the payoff from L. After temporary divergence, both sub-populations tend toward L strategies.

Divergence leads to two additional evolutionary paths:

3. **Divergence undermines virtuous cycle**: Consider parameters such that the payoffs to using law are lower than the payoffs to force for strong firms; the payoffs to using law are higher than the payoffs to force for weak firms; *and* when firms have equal resources,

\[ \lambda_{S,L}^{*}(\lambda_{W,L}) \]

indicates that the threshold for strong firms is a function of the proportion of weak firms using L.

\[ \psi \]

It can be shown that this will hold for a large enough \( \psi \), the proportion of strong firms.
the payoffs to using law are higher than to force. Then with equal resources, a virtuous cycle toward law happens with certainty. With unequal resources, a virtuous cycle will occur only if the divergence among strong and weak firms is temporary. That is, only if there is a sufficient proportion of weak firms will evolution of the economy toward law occur. Otherwise, the economy converges to a stable environment in which strong firms use force and weak firms use law.

4. **Divergence provides opportunity for virtuous cycle:** Consider parameters such that the payoffs to using law are lower than the payoffs to force for strong firms; the payoffs to using law are higher than the payoffs to force for weak firms; and when firms have equal resources, the payoffs to using law are lower than to force. Then with equal resources, a vicious cycle toward force happens with certainty. With unequal resources, by contrast, it is possible that a virtuous cycle will occur, given a sufficient proportion of weak firms. If the divergence among strong and weak firms is temporary, then the rising number of weak firms using law eventually shifts payoffs until it is beneficial for strong firms to use law as well.

This analysis thus indicates that unequal access to resources for non-legal strategies can indeed affect demand for law, but that the relationship is complex and multifaceted. An important caveat is that here the share of strong and weak firms in the population remains constant. Additional analyses will be required to consider the effect of allowing the share of firm types to evolve in addition to the share of firms using legal versus non-legal strategies.
Chapter 4

Transforming Incentives and the Demand for Law

This chapter examines the factors contributing to the transformation in Russian firms’ property security strategies. As discussed in Chapter 1, firms shifted from the use of force to the use of law to protect assets not because businesspeople developed a normative conviction in the importance of law. Nor was the shift from force to law simply a response to the state’s increased enforcement capacity. Rather, the shift occurred because changes in firms’ incentive structures made it less advantageous to use force and more advantageous to use law.

This focus on incentives in societies in which institutions themselves are in flux creates something of a conundrum. After all, institutions are usually considered to shape incentives structures, so what molds actors’ incentives when institutions are malleable? Some scholars have concluded that during periods of institutional instability, interest group politics takes on a more determinative role (Elster et al. 1998; Schwartz 2006; Shleifer and Treisman 2001). This is indeed a reasonable assessment when the issue under analysis is the formation of formal rules and legislation. But what of compliance and firm behavior, which by definition involve numerous, smaller actors rather than a handful of powerful interest groups?

This chapter offers three sets of answers regarding the sources of incentive transformations during periods of institutional flux. Incentive shifts can result from: (1) organizational changes within firms, such as the evolution of firms’ ownership structures; (2) evolution in other institutional spheres, such as the development of the tax administration and banking sector; and (3) external pressures, such as the inflow of foreign investment.

The transformation from protecting property claims to enforcing property rights is a multifaceted process, and attributing complex transitions to a handful of key variables warrants
caution. However, the factors emphasized in this chapter are those that Russian businesspeople, lawyers, and directors of private security agencies repeatedly discussed during in-depth interviews. Given the early state of research on the demand-side of institution building, it seems reasonable to begin analysis with the factors that Russia’s private sector actors — that is, the people who have had the front row seat to the evolution of Russia’s economy — deem most important.

Naturally, the perception of market participants can be skewed, and respondents may intentionally or inadvertently offer misguided assessments. For all of the granular insights they possess from daily immersion in the Russian business world, respondents often lack systematic data on broader trends in the economy. Inductively gleaned insights, therefore, are merely a starting point. For each inductively derived hypothesis, the analysis in this chapter seeks to establish evidence that significant shifts in the proposed explanatory variables have occurred. When they have, I then trace the chain of causal logic linking explanatory factors and property security strategies. If there is evidence of a causal chain, then, where possible, I use survey data to ascertain whether a correlation between these factors and firms’ strategies indeed exists. The goal is not only to establish which factors affect firms’ property security strategies but also to illustrate how transformations in the demand-side of institutional development occur.

The focus here is on transformations over time, particularly changes beginning in the late 1990s and continuing through the present day. However, the factors discussed did not affect all types of firms equally. The analysis therefore offers insights into the types of firms that might form the vanguard in the transition from force to law. The topic of distinctions across firms is then taken up at length in the subsequent chapter.

4.1 The Evolution of Ownership Structures

The transformation of the Russian economy since the financial crisis of 1998 has been nothing short of astounding. Following a prolonged depression in the wake of the Soviet Union’s collapse, Russia enjoyed robust growth for a full decade until the worldwide economic crisis of 2008, as seen in Figure 4.1. Furthermore, Table 4.1 provides evidence that economic growth spread far beyond the natural resources sector. For example, natural resource wealth poured into real estate, leading to a construction boom, which in turn supported a renaissance of the machine-building sector. But the transformation that began in the late 1990s was not simply an economic expansion. It was a wholesale reorganization of ownership structures, which led to accompanying changes in owners and managers’ mentality and business practices. In many ways, the resurrection of Russia after the chaos of the early 1990s was a transformation akin to the shift from the anarchy of feudalism to the rules-based capitalism of modern Europe, but compressed into less than two decades.
Two elements of this transformation of ownership structures were particularly crucial for the shift in property security strategies: (1) the consolidation of ownership in privatized firms and (2) the modernization of the workplace, which shifted commerce from small shops and open-air markets into large, modern shopping centers and office buildings. These changes altered firms’ goals and incentives, transformed the threats and challenges firms face, and changed the resources at firms’ disposal for protecting assets.

### 4.1.1 Consolidation of Ownership within Privatized Firms

One of the most important aspects of Russia’s economic transformation with respect to property security strategies has been the consolidation of ownership within privatized firms. Privatization created firms with highly dispersed ownership structures. With minimal protection for minority owners’ rights, limited oversight of managers, and no dominant owner, all parties with control over cash flows or physical assets faced perverse incentives: Transferring resources to front companies or selling off valuable property and pocketing the proceeds — processes known as “asset stripping” — proved a much surer and quicker path to enrichment than long-term investment. Long-term investment became appealing only once dominant owners emerged and consolidated control over their assets. Meanwhile, once they accumulated assets, owners became more risk averse; with long-term investments in mind, they came to value stability. Consequently, the relative cost of property security strategies based on force and corruption increased, facilitating a shift toward law.

The privatization of Soviet industry was by far the largest reallocation of assets in human
Table 4.1: GDP Growth by Key Sectors, 2003-2010

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>Q1 2010</th>
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<tbody>
<tr>
<td>Total GDP Growth</td>
<td>7.3</td>
<td>7.2</td>
<td>6.4</td>
<td>8.2</td>
<td>8.5</td>
<td>5.2</td>
<td>-7.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Agriculture and Forestry</td>
<td>5.5</td>
<td>3.0</td>
<td>1.1</td>
<td>2.7</td>
<td>1.3</td>
<td>7.3</td>
<td>0.2</td>
<td>2.7</td>
</tr>
<tr>
<td>Extraction Industries</td>
<td>10.8</td>
<td>7.9</td>
<td>0.5</td>
<td>-2.9</td>
<td>-2.2</td>
<td>1.7</td>
<td>-0.9</td>
<td>11.7</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>9.5</td>
<td>6.7</td>
<td>6.0</td>
<td>6.6</td>
<td>7.5</td>
<td>-2.2</td>
<td>-15.8</td>
<td>13.4</td>
</tr>
<tr>
<td>Electricity, gas, and water</td>
<td>1.6</td>
<td>2.0</td>
<td>1.2</td>
<td>4.5</td>
<td>-3.4</td>
<td>-0.3</td>
<td>-4.3</td>
<td>9.0</td>
</tr>
<tr>
<td>Construction</td>
<td>13.0</td>
<td>10.3</td>
<td>10.5</td>
<td>12.8</td>
<td>13</td>
<td>11.2</td>
<td>-17.2</td>
<td>-8.9</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>13.2</td>
<td>9.2</td>
<td>9.4</td>
<td>14.1</td>
<td>11.7</td>
<td>9.4</td>
<td>-10.3</td>
<td>-0.1</td>
</tr>
<tr>
<td>Transport and Communications</td>
<td>9.6</td>
<td>9.9</td>
<td>11.9</td>
<td>9.7</td>
<td>4.8</td>
<td>5.1</td>
<td>-3.0</td>
<td>9.5</td>
</tr>
<tr>
<td>Financial Services</td>
<td>7.2</td>
<td>10.9</td>
<td>6.2</td>
<td>25.4</td>
<td>29.1</td>
<td>13.5</td>
<td>2.4</td>
<td>-7.3</td>
</tr>
</tbody>
</table>

history. In a brief four years, between 1992 and the end of 1995, over one hundred thousand small enterprises and nearly eighteen thousand medium and large firms were transferred to private owners (Blasi et al. 1997, 189). An asset transfer of such a scale set off a vicious struggle over ownership and control of enterprises. These struggles were exacerbated by the method of privatization used. Reformers aimed to conduct privatization rapidly to make a return to the Soviet command economy impossible, but they faced a population deprived of capital. To address this problem, and to build popular support for reforms, Yeltsin’s reform team created a program that would swiftly transfer assets to Russian workers and citizens. Citizen received vouchers exchangeable for shares in privatizing enterprises, and workers received privatization accounts and other means of financial support allowing them to become shareholders in their place of employment.

The privatization program resulted in highly fractured ownership structures that were spread across workers, managers, investment funds, individuals, and firms with cross-holdings. Workers in particular acquired significant shares, leading to widespread de jure employee ownership (as seen in Table 4.2). In reality, however, managers pressured workers into selling their shares or turning over de facto control rights. Entrenched inside owners further complicated the problem of dispersed ownership, as managers fought to avoid restructuring that could increase outside ownership.

Despite insiders’ resistance, the financial crisis of 1998 instigated a significant transformation in ownership structures. Tycoons who weathered the crisis acquired assets from failing enterprises or competing business groups. Shaken by the economic collapse, owners placed increased value on longer-term stability. Meanwhile, the ruble’s depreciation made the manufacturing sector competitive for the first time since communism’s collapse, increasing the value of investment in productive assets. By the early 2000s, a fundamental ownership shake-up had occurred. Outsiders had on average acquired a majority of shares, while insiders held less than one-third, as seen in Table 4.2. This increase in outside ownership was closely linked to owners’ efforts to acquire a dominating share of enterprise assets, in part by reducing the influence of managers, whose average share of ownership dropped significantly by the turn of the decade (Radygin and Arpikhov 2001, 15). These efforts to consolidate assets were successful. As seen in Table 4.3, following privatization less than 15 percent of firms had a shareholder with a majority stake. By the mid-2000s, approximately three-fourths of firms had such a shareholder.

This concentration of ownership transformed owners’ incentive structure, raising the cost of using property security strategies based on force. With undisputed control of enterprises,

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1 For an overview of the privatization process, see Åslund (1995, ch. 7) and Blasi et al. (1997, ch. 1).
2 Comparison of surveys from different sources requires caution, as there are differences in sample size and composition across the studies. Nevertheless, while these figures should be considered a rough approximation, existing sources are unanimous in their assessment of a significant trend toward outside ownership and ownership concentration in privatized firms from the late 1990s through the early 2000s.
### Table 4.2: Ownership Structure of Russian Industrial Firms

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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Insiders</td>
<td></td>
<td></td>
<td>49.1</td>
<td>44.4</td>
<td>25.0</td>
<td>31.6</td>
<td>36.4</td>
</tr>
<tr>
<td>Managers</td>
<td></td>
<td></td>
<td>10.6</td>
<td>14.8</td>
<td>9.4</td>
<td>7.2</td>
<td>17.0</td>
</tr>
<tr>
<td>Workers</td>
<td></td>
<td></td>
<td>35.9</td>
<td>29.2</td>
<td>28.5</td>
<td>20.4</td>
<td>15.7</td>
</tr>
<tr>
<td>Other</td>
<td></td>
<td></td>
<td>--</td>
<td>--</td>
<td>4.2</td>
<td>4.0</td>
<td>3.7</td>
</tr>
<tr>
<td>Outsiders</td>
<td></td>
<td></td>
<td>17.5</td>
<td>32.7</td>
<td>46.5</td>
<td>55.6</td>
<td>55.4</td>
</tr>
<tr>
<td>Legal entities</td>
<td></td>
<td></td>
<td>11.1</td>
<td>19.6</td>
<td>21.4</td>
<td>35.7</td>
<td>26.5</td>
</tr>
<tr>
<td>Individuals</td>
<td></td>
<td></td>
<td>4.1</td>
<td>9.2</td>
<td>22.2</td>
<td>15.2</td>
<td>27.4</td>
</tr>
<tr>
<td>Foreigners</td>
<td></td>
<td></td>
<td>1.5</td>
<td>3.2</td>
<td>2.9</td>
<td>4.7</td>
<td>1.5</td>
</tr>
<tr>
<td>State</td>
<td></td>
<td></td>
<td>33.0</td>
<td>22.6</td>
<td>11.4</td>
<td>12.8</td>
<td>8.2</td>
</tr>
</tbody>
</table>


### Table 4.3: Ownership Concentration: Percent of Russian Industrial Firms with Large Shareholder

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>25%</td>
<td>44.5</td>
<td>46.8</td>
<td>55.2</td>
<td>67.1</td>
<td>42.0</td>
<td>75.0</td>
<td>83.0</td>
</tr>
<tr>
<td>50%</td>
<td>14.8</td>
<td>19.6</td>
<td>32.0</td>
<td>39.5</td>
<td>19.0</td>
<td>48.0</td>
<td>75.0</td>
</tr>
</tbody>
</table>

Sources: Data for 1995 and 1998a are from a Higher School of Economics (HSE) survey conducted in 1999, as cited in Dolgopyatova (2004, 7); data for 1998b and 2001 are from an HSE survey conducted in 2002, as cited in Dolgopyatova (2004, 7); data for 2002 and 2004 are from IFC as cited by Lazarev et al. (2007, 6); data for 2005 are from Dolgopyatova (2009, 86).
owners could now reap gains from long-term investments without fear that competing owners or asset-stripping managers would dilute their profits (Yakovlev et al. 2003, 145). Longer-term investment requires stability and predictability, and owners recognized that asset battles that use force undermine a stable and predictable environment. Consolidation of ownership also changed owners’ incentive structure in another way. Having acquired significant and valuable assets, owners no longer wanted to wage battles using strategies that entailed the risk of physical harm or incarceration. As succinctly stated by a prominent bankruptcy lawyer in Moscow, the mentality of today’s businesspeople — in contrast to the 1990s — is that “You can risk in business, but not in life” (author interview, 9 March 2009, 090309-L3). Unlike the initial period after the collapse of communism, by the 2000s, businesspeople had significant assets to lose, which increased aversion to risk.

Russian business journalists, academics, and businesspeople attribute a wide range of developments to ownership consolidation — improvements in corporate governance (Potanin 2003), a reduction in illegal corporate raiding (Volkov 2004), and rising demand for talented managers (Shabanova 2010). Yakovlev et al. (2003, ch. 3), in a study based on in-depth interviews with managers and owners, suggested that concentration of ownership was contributing to a demand for more effective and formal legal institutions. If this hypothesis is correct, then privatized firms with consolidated ownership should be less likely than other privatized firms to use property security strategies based on force. In the survey I conducted, respondents were asked, “Does your firm have a single owner or an owner with a controlling packet of shares?” Of the 301 respondent firms, 78 were privatized firms. Of these, 45 — approximately 58 percent — report consolidated ownership.

I then reconsidered the data described in Chapter 2 regarding firms’ preferred strategies for dealing with a property dispute (see Table 2.4). Respondents were given a scenario in which another firm seeks to acquire control of some of its assets and asked to rate on a scale of 1 to 7, where 1 means “very unlikely” and 7 means “very likely,” how likely they would be to use each possible strategy to resolve the dispute (e.g., go to court, seek help through informal connections with bureaucrats, hire a private security agency, etc.). In the regression analyses shown in Table 4.4, firms’ rankings on a 1 to 7 scale of their likeliness to use a given strategy to resolve an asset conflict are the dependent variable. The independent variable of interest is labeled “consolidated,” and takes a value of 1 if the firm has a dominant owner and 0 otherwise. To account for factors that might be correlated with firms’ preferred strategies and therefore confound analyses, I include control variables for firm size (measured in number of employees) and dummy variables for city and sector.

---

3 Respondents were asked the following question: Let’s say that a competitor is trying to gain control of some significant physical asset owned by your firm (e.g., office space or a factory). To defend its assets, how likely would a firm like yours be to do each of the following?

4 Because the sub-sample of privatized firms is relatively small, I include limited control variables in the model specification shown. As an alternative specification, I analyzed the entire sample and interacted a
The regression analyses in Table 4.4 support the hypothesis that firms with consolidated ownership are less likely to resolve an asset conflict using property security strategies based on corrupt or private force, such as using courts along with informal connections in the judiciary, turning to bureaucrats or law enforcement officials in their unofficial “private” capacity, or using an internal security service. The coefficients on the “consolidated” variable are statistically significant at standard levels and negative in sign. They are also substantively significant. On the 1 to 7 scale of likeliness, privatized firms with consolidated ownership on average rank their likeliness to use strategies based on force more than a full point lower (or 14 percent of the scale’s total range) than other privatized firms. I then repeated the analysis using data on firms’ preferred strategies for collecting a debt in place of data on firms’ preferred strategies for resolving an asset conflict. The results were nearly identical.

Naturally, the results of cross-sectional regression analyses should be interpreted with some caution. Ideally, we would be able to test the hypothesis with panel data and track how individual firms’ property security strategies change over time as their ownership structures evolve. Yet even in the absence of such data, the results of in-depth interviews with firms and lawyers, observations by Russian business journalists, and analysis of survey data lead to a similar conclusion: The consolidation of ownership has contributed to the shift from force to law among Russia firms.

4.1.2 Modernization of the Workplace and Marketplace

Just as consolidation of ownership transformed owners’ incentive structures, the dramatic expansion of modern shopping centers, office buildings, and chain stores contributed to the transformation in Russian firms’ property security strategies. Whereas the kiosks and open-air markets that flourished after the fall of the Soviet Union facilitated strategies based on force, these new types of real estate and ownership structures provided firms with protection and resources that promoted a shift toward reliance on law.

Following the collapse of communism, trade thrived in a society starved for consumer goods.

\footnote{OLS regressions are shown here. Ordered probit regressions produced similar results. All statistically significant results throughout this chapter remain unchanged if robust standard errors are used.}

\footnote{The coefficients on the models for use of criminal protection rackets and private security agencies (not shown here) are negative in sign, as predicted, but are not statistically significant.}

variable for privatization (1 if the firm was created through privatization, 0 otherwise) and a variable for consolidation (1 if the firm has a dominant owner, 0 otherwise). In this model, I used a fuller set of control variables, including age of respondent, gender of respondent, presence of state and foreign shareholder (coded as 1 if the state or foreign owner holds more than 10 percent of shares, and 0 otherwise), membership in a business association, firm size (as measured in number of employees), and dummy variables for city and sector. The coefficients on the interaction variable are statistically significant and the results are substantively similar to those presented in Table 4.4.
Table 4.4: Ownership Consolidation and Use of Force to Resolve Property Conflicts

OLS Regressions

<table>
<thead>
<tr>
<th></th>
<th>Courts (informal connections)</th>
<th>Bureaucrats (private capacity)</th>
<th>Law Enforcement (private capacity)</th>
<th>Internal Security</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept)</td>
<td>7.10 **</td>
<td>4.62 **</td>
<td>5.45 ***</td>
<td>1.88</td>
</tr>
<tr>
<td></td>
<td>(1.72)</td>
<td>(1.45)</td>
<td>(1.52)</td>
<td>(1.80)</td>
</tr>
<tr>
<td>consolidated</td>
<td>-1.08 †</td>
<td>-1.06 *</td>
<td>-1.05 *</td>
<td>-1.05 †</td>
</tr>
<tr>
<td></td>
<td>(0.56)</td>
<td>(0.47)</td>
<td>(0.49)</td>
<td>(0.58)</td>
</tr>
<tr>
<td>log(employees)</td>
<td>-0.47 †</td>
<td>-0.18</td>
<td>-0.30</td>
<td>0.47 †</td>
</tr>
<tr>
<td></td>
<td>(0.26)</td>
<td>(0.22)</td>
<td>(0.23)</td>
<td>(0.27)</td>
</tr>
<tr>
<td>city dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>sector dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>(N)</td>
<td>74</td>
<td>76</td>
<td>75</td>
<td>73</td>
</tr>
<tr>
<td>(R^2)</td>
<td>0.18</td>
<td>0.25</td>
<td>0.20</td>
<td>0.14</td>
</tr>
<tr>
<td>adj. (R^2)</td>
<td>0.11</td>
<td>0.18</td>
<td>0.13</td>
<td>0.06</td>
</tr>
<tr>
<td>Resid. sd</td>
<td>2.24</td>
<td>1.91</td>
<td>1.99</td>
<td>2.34</td>
</tr>
</tbody>
</table>

Standard errors in parentheses

† significant at \(p < .10\); *\(p < .05\); **\(p < .01\); ***\(p < .001\)

Virtually overnight, kiosks and open-air markets appeared, supplied by an army of shuttle traders (chelnoki) hustling between Russian markets and low-cost producers in places such as China and Turkey. In Central and Eastern Europe, kiosks and open-air markets gave way rapidly to modern shopping centers, but in much of the former Soviet Union, they persisted throughout the 1990s. This was in part because Soviet urban planning bequeathed Russia with minimal space suitable for commercial real estate. Furthermore, the meager growth of the Russian economy in the 1990s produced limited capital for the construction of modern retail space. Consequently, retail formats that required minimal space and start-up capital, such as kiosks and open-markets, continued to dominate the retail sector (Axenov et al. 1997). Although a handful of modern supermarket chains sought to enter the Russian market in the late 1980s and early 1990s, they focused predominantly on the elite market. Some of the chains that would see rapid expansion in the 2000s, such as Sedmoi Kontinent and Perekrestok, first appeared in the mid-1990s, but until the end of the decade, their impact on consumer habits was minimal (Radaev 2008, 14-17).

\(^7\) The author also would like to express his appreciation to Olesya Cherdantseva, Head of Retail and Capital
Table 4.5: Expansion of Moscow Shopping and Business Centers, 2002-2010

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shopping Center Stock</td>
<td>538</td>
<td>643</td>
<td>963</td>
<td>1,201</td>
<td>1,516</td>
<td>1,872</td>
<td>2,152</td>
<td>2,646</td>
<td>3,037</td>
</tr>
<tr>
<td>Modern Office Stock</td>
<td>2,923</td>
<td>3,548</td>
<td>4,291</td>
<td>5,160</td>
<td>6,347</td>
<td>8,019</td>
<td>10,068</td>
<td>11,740</td>
<td>12,654</td>
</tr>
</tbody>
</table>

Data provided by Daniel Demytrie, Head of Research at Jones Lang LaSalle, Russia & CIS in response to author’s correspondence.\(^7\)

The growth unleashed in the aftermath of the 1998 financial crisis spurred a revolution in consumer demand, leading to rapid expansion in the retail sector. The development of three types of ownership structures was of considerable importance for property security strategies: modern shopping centers, business centers, and chain stores. With profits to be made in retail, investment in modern shopping centers (*torgovye tsentry*) boomed. Throughout the 2000s, the expansion of Russia’s gross leasable area (GLA) in shopping centers was astronomical, as seen for Moscow in Table 4.5. Similarly, in 1994 St. Petersburg had a meager 0.15 square meters of shopping center GLA per 1000 inhabitants; by 2010, it had over 300 square meters per 1000 inhabitants, above the EU-27 average.\(^8\) Nor was this transformation limited to St. Petersburg and Moscow. Shopping center expansion in Russia’s “millioniki” — cities outside of Moscow and St. Petersburg with over a million inhabitants — in recent years has outpaced that of Moscow (Jones Lang LaSalle 2009, 8). The arrival of modern shopping centers transformed the ways that Russians consume, pushing aside kiosks, open-air markets, and “traditional” Soviet-era shops, as indicated in Table 4.6(a).

With the commercial real estate market thriving and the economy as a whole expanding, a similar transformation occurred with respect to office space, further reshaping the Soviet urbanscape. As with retail, Soviet planners created buildings and cities ill-suited for the modern business world. Although nearly non-existent at the turn of the century, top-grade business centers (*delovye tsendry*) rapidly expanded throughout the 2000s, as seen for Moscow in Table 4.5. Despite this construction boom, prices for office space continue to skyrocket and firms continue to complain of shortages, indicating a nearly insatiable demand for such real estate.

A third key development was the expansion of chain stores. Following the 1998 crisis, a cohort of discounters, such as *Diksi*, *Pyaterochka*, *Magnit*, and *Kopeika*, joined the pioneer-

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Markets Research, and Olga Rybakova, Head of Office and Warehouse Research, at Jones Lang LaSalle, Russia & CIS.

\(^8\) 1994 figure is from Axenov et al. (1997, 21); 2010 figure is from Jones Lang LaSalle (2010b, 3); EU-27 figure from Cushman & Wakefield (2010, 2).
ing supermarket chains of the mid-1990s. As the retail boom continued into the 2000s, international powerhouses such as Metro Group and Auchan Group arrived, building huge “hypermarts” or semi-wholesalers (Radaev 2008, 14-17). From consumer electronics to home repair, modern shopping formats have come to dominate Russian markets. Offering higher quality, better prices, and the aura of economic progress, these retailers edged aside other types of shopping formats. Regional governments further accelerated this trend by passing legislation aimed at reducing the number of open-air markets, which were associated with informality, illegal immigrants, and tax evasion (Kotelnikova 2008). For example, in the food retail sector, chain stores accounted for less than one percent of sales in 2000; by 2005 they accounted for nearly a quarter, as seen in Table 4.6(b). The spread of chains, although initially limited to Moscow and St. Petersburg, rapidly occurred throughout Russia. By 2007 Magnit operated in 41 regions, and the X5 retail group, owner of Pyaterochka and Perekrestok, in 26 (Radaev 2008, 15).

Table 4.6: Transformation of Retail Formats

(a) Share of Consumer Purchases by Shopping Format in Consumer Goods Sector (% of all purchases)

<table>
<thead>
<tr>
<th>Format</th>
<th>2000</th>
<th>2003</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Modern Self-Service</td>
<td>9</td>
<td>17</td>
<td>30</td>
</tr>
<tr>
<td>Traditional Soviet Format</td>
<td>22</td>
<td>23</td>
<td>20</td>
</tr>
<tr>
<td>Kiosks</td>
<td>20</td>
<td>15</td>
<td>13</td>
</tr>
<tr>
<td>Open-Air Markets</td>
<td>33</td>
<td>28</td>
<td>23</td>
</tr>
<tr>
<td>Other Formats</td>
<td>16</td>
<td>17</td>
<td>14</td>
</tr>
</tbody>
</table>

Source: PricewaterhouseCoopers (2005, 142)

(b) Chain Stores' Share of Sales in Food Retail Market (% of all sales)

<table>
<thead>
<tr>
<th>Year</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>0.1</td>
<td>1.0</td>
<td>2.7</td>
<td>4.5</td>
<td>8.0</td>
<td>15.6</td>
<td>24.0</td>
</tr>
<tr>
<td>Moscow</td>
<td>0.2</td>
<td>2.3</td>
<td>8.0</td>
<td>20.0</td>
<td>24.0</td>
<td>30.0</td>
<td>33.0</td>
</tr>
</tbody>
</table>

Source: Radaev (2006, 31); RosBiznesKonsalting (2006, 27)

The expansion and development of shopping centers, business centers, and chain stores changed firms’ calculus of property security strategies by altering the types of threats firms
CHAPTER 4. TRANSFORMING INCENTIVES

faced and the resources at their disposal. Open-air markets were closely tied to the types of strategies based on physical force discussed in Chapter 2. Infamous open-air markets, such as the Рижский рынок and рынок Лужники in Moscow, were birthplaces of criminal protection rackets (Modestov 1996). Physically, stalls at open-air markets or kiosks on the street were vulnerable to attacks. Meanwhile, sellers at these markets operated on the margins of the formal economy, rarely paying taxes and remaining under the radar screen of government authorities. This limited their ability to turn to formal law official agencies or to courts in times of duress.

By contrast, modern commercial real estate provides for security. In Russian business centers, security guards screen visitors’ documents before allowing entrance. At shopping centers, shoppers pass through metal detectors and security guards patrol the premises. It is now virtually impossible to impose the types of physical threats that were prevalent in the 1990s on shopkeepers who have relocated to modern malls. Essentially, shopping centers and business centers have changed the level at which protection rackets take place. As the owner of an IT outsourcing business in Moscow explained:

If we are to talk about the meaning of a krysha, then we don’t have one. But if our store were bigger, if our turnover were greater than 10 million rubles, then the shopping center where we are located, they would have “their people,” and these people would take about 10 percent of revenues. . . . We would have to pay them an official bank transfer of about 10 percent for some services, such as security. That is, it’s official, there’s nothing like some racketeer thugs who come around to collect money in a bag (author interview, 23 November 2009, 112309-F34).

In effect, retailers located in shopping centers outsource property security to the center’s management. If they are harassed by government inspectors or threatened by a competitor, they have someone to whom they can turn. This is not to say that the development of commercial real estate fully eradicates corruption and force. As a Moscow lawyer with many clients in the construction business explained, it is impossible to build and maintain a major commercial real estate center in the capital without connections to the city authorities (author interview, 19 May 2009, 091909-L17). But by centralizing conflict among a few powerful parties, the transformation from street-level commerce to modern retail formats frees the vast majority of people doing business to operate in the realm of law.

Chain stores transform property security strategies through other mechanisms. While they do not provide the same level of physical security as shopping or business centers, they similarly centralize property security at a high level of powerful actors — the corporate headquarters. Rather than relying on low-level connections or physical force, conflicts are turned over to executives. At the larger chains, these executives face the pressures and

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9 As discussed in Chapter 2, krysha (literally the Russian word for “roof”) refers to a criminal protection racket.
Table 4.7: Chain Stores and Use of Force to Resolve Property Conflicts

Average responses on a scale of 1 to 7, where 1 is “very unlikely” and 7 is “very likely”

<table>
<thead>
<tr>
<th></th>
<th>Chain Stores</th>
<th>Other Respondents</th>
<th>T-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Courts</td>
<td>2.67</td>
<td>4.63</td>
<td>-2.03†</td>
</tr>
<tr>
<td>(with informal connections)</td>
<td>(7, 0.84)</td>
<td>(111, 0.20)</td>
<td></td>
</tr>
<tr>
<td>Bureaucrats</td>
<td>2.50</td>
<td>3.92</td>
<td>-1.91</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(7, 0.72)</td>
<td>(118, 0.19)</td>
<td></td>
</tr>
<tr>
<td>Law Enforcement</td>
<td>2.50</td>
<td>4.02</td>
<td>-2.04†</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(7, 0.72)</td>
<td>(117, 0.20)</td>
<td></td>
</tr>
<tr>
<td>Mafia</td>
<td>1.83</td>
<td>1.90</td>
<td>-0.08</td>
</tr>
<tr>
<td>(7, 0.83)</td>
<td>(114, 0.15)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal Security Service</td>
<td>2.0</td>
<td>3.6</td>
<td>-2.70*</td>
</tr>
<tr>
<td>(6, 0.55)</td>
<td>(114, 0.20)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private Security Agency</td>
<td>1.83</td>
<td>1.91</td>
<td>-0.11</td>
</tr>
<tr>
<td>(7, 0.65)</td>
<td>(113, 0.13)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

† $p < .10$; *$p < .05$

Note: Mean values with the number of observations and standard errors in parentheses.

scrutiny of shareholders, who in many cases — especially for transnational companies or companies that rely on foreign investors — will not tolerate illegal and violent means of resolving conflicts. In order to ensure accountability and monitor cash flows, corporate headquarters also put downward pressure on local managers to follow company procedures, which impedes the allocation of resources for illicit property security strategies.

The transformation of commercial real estate and retail formats is highly visible, and interviews with businesspeople and private security agencies indicate that this transformation has contributed to the shift in property security strategies. Yet to the best of my knowledge, systematic data has not been collected that would allow for investigation of shopping and business centers’ effect on firms’ strategies for protecting assets. My survey did, however, inquire as to whether respondents were members of a set of chain stores. Only 8 of the 301 firms in the sample answered in the affirmative, yet even with this highly unbalanced sample, some preliminary evidence emerges. All but one of these 8 firms had over 250 employees, so for the sake of comparability, I include in the analysis only firms in this size range. As above, I consider data on firms’ preferred strategies for dealing with an asset conflict, where
firms rated on a 1 to 7 scale their likeliness of using a given strategy, with 1 meaning “very unlikely” and 7 meaning “very likely.”

With so few chain stores in the sample, the estimates are imprecise, and it makes little sense to utilize multiple regression analyses. I instead conducted basic difference-in-means tests, as shown in Table 4.7. Even with the handful of chain stores in the sample, statistically significant differences are identifiable. On average, the chains are significantly less disposed to property security strategies that rely on corrupt or private force. In the case of using informal connections in court, the average response on a 1 to 7 scale for chain stores was nearly two full points lower than for other respondents (about 28 percent of the scale’s total range). The average response for using law enforcement in a non-official capacity or turning to an internal security service was approximately 1.5 points lower.

In summary, the existing evidence suggests that the transformation of ownership structures has contributed to the shift in firms’ property security strategies. Two changes in particular — the consolidation of ownership in privatized firms and the modernization of the marketplace — have altered firms’ incentives, transformed the types of threats firms face, and placed new resources at firms’ disposal. The result has been a shift from force to law.

4.2 Complementarities of Institutional Development

Analyses of legal development frequently focus on judicial and law enforcement institutions. These are no doubt important, but there are limits as to how much property security strategies will change in response to improvements in courts and judges. Without development in other spheres, firms may face strong disincentives to use legal institutions. For example, when corrupt and inefficient tax administration prevents firms from paying their full share of taxes, businesspeople will be less willing to rely on law for fear of exposing their own legal violations. Meanwhile, other types of institutional developments raise the costs of using force. Development of the banking sector, for instance, reduces firms’ reliance on cash transactions, which complicates the use of bribes, reliance on criminal rackets, hiring of government officials to attack competitors, or other illegal property security strategies.

During debates over economic reforms in the early 1990s, scholars directed attention to complementarities among economic reform programs such as price liberalization, privatization, and macroeconomic stabilization (Roland 2004). Complementarities are also at the core of recent theories of varieties of capitalism, which posit that distinctive institutional regimes persist because the interaction of their parts creates positive externalities for the system as a whole (Hall and Soskice 2001). Yet little is known about how such institutional regimes emerge, nor have theories of complementarities gained traction in studies of property rights.
and legal development.\textsuperscript{10} Russia’s transformation therefore provides a unique opportunity to gain insights into the interplay of institutional spheres and the emergence of institutional regimes. With these goals in mind, this section examines the effects on property security strategies of development in two institutional spheres: tax administration and banking sector development.

### 4.2.1 Tax Administration

The Soviet legacy left Russia with a tax system fundamentally ill-suited for a modern market economy, requiring a long period of chaotic adaptation. Until reforms in the late 1990s, nearly all firms were engaged in tax violations and informal dealings with tax officials. As a result, even during times of duress, they hesitated to turn to formal legal institutions for fear of exposing their own legal shortcomings. It was not until the late 1990s and early 2000s, when a new Tax Code and tax administration reform took effect, that firms began to pay taxes and emerge from the shadow economy. Subsequently, the cost of using law relative to force decreased, contributing to the shift in property security strategies.

In the Soviet command economy, where all productive assets were owned by the state, taxation served as a tool for resource allocation among enterprises and ministries, rather than as a means of extracting revenue from private entities. Consequently, following the collapse of the Soviet Union, Russia’s tax administration was underdeveloped and highly dependent on a narrow tax base composed of large, recently privatized firms and the remaining state-owned enterprises. In the mid-1990s, taxes on Russia’s 20 most profitable companies accounted for approximately two-thirds of federal government revenues. Regional governments were similarly dependent on tax revenues from one or a handful of large firms (Easter 2002, 615).

Amidst the chaotic rush to liberalize prices and privatize firms during the first years of post-communism, institutional reforms such as tax administration received secondary attention. Rather than establishing clearly defined and formal rules, the government soon lapsed into Soviet-style tactics of case-by-case negotiations, alternately granting firms exemptions and utilizing threats to coax tax payment. Meanwhile, in an effort to limit secessionism, Yeltsin exempted many regional governors from transferring taxes to the federal government (Easter 2002, 614-615). Between 1993 and 1997, Yeltsin also granted regional and local governments the right to implement new taxes (Shleifer and Treisman 2000, 118). By the late 1990s, there were over 200 different taxes, about 170 of them implemented at the sub-national level, creating a hodgepodge of tax regulation that was impossible for even well-intentioned firms to untangle (Himes and Millet-Einbinder 1999, 170). By some accounts, the aggregate tax rate came close to 100 percent of enterprise profits. In response, firms began to conduct

\textsuperscript{10}One exception is the work of Jonathan Hay and collaborators, who suggested that tax reform should precede legal reform due to complementarities (see Alexeev et al. 2004; Hay and Shleifer 1998).
Figure 4.2: Tax Revenues and Arrears to Consolidated Budget of RF, 1992-2008

((% of GDP)


many transactions through barter, in part in order to keep assets hidden from tax authorities (Shleifer and Treisman 2000, 95-97). Meanwhile, firms developed numerous schemes to reduce their tax burden, such as underreporting sales, number of employees, or amount of wages paid (Yakovlev 2001). The results were devastating for state finances. As seen in Figure 4.2, tax arrears rose from under 2 percent of GDP in 1993 to 9.4 percent of GDP following the financial crisis of 1998. This amounted to a staggering 46 percent of tax revenues to the consolidated budget (Libman and Feld 2007, 8).

This unsustainable system soon brought the state to the edge of fiscal collapse. Figure 4.2 shows how tax revenues to the consolidated budget dropped precipitously from around 30 percent to 20 percent of GDP between 1992 and the 1998 financial crisis, even as GDP itself shrank amidst a prolonged and severe recession. In panic, the state sought to crack down and instill discipline among taxpayers. The government expanded tax collectors’ authority, sent armed masked agents of the Tax Police on highly visible raids against debtor firms, and created a high-profile Temporary Extraordinary Commission for Improving Tax and Budget Discipline (Shleifer and Treisman 2000, 143-144). These measures further undermined trust between firms and the state, leading to additional tax evasion and temporary ad hoc agreements that failed to increase tax revenue on a sustained basis.

Significant changes finally occurred in the late 1990s, when reform efforts that had been stalled since the mid-1990s resulted in a new Tax Code. The 1998 financial crisis made re-structuring of government finances imperative in order to receive bailouts from international
CHAPTER 4. TRANSFORMING INCENTIVES

Table 4.8: Reporting Sales for Tax Purposes

(% of firms)

<table>
<thead>
<tr>
<th></th>
<th>1999 (N=552)</th>
<th>2002 (N=506)</th>
<th>2005 (N=601)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Report 100% of sales</td>
<td>28</td>
<td>53</td>
<td>60</td>
</tr>
<tr>
<td>Report more than 90% of sales</td>
<td>42</td>
<td>59</td>
<td>65</td>
</tr>
<tr>
<td>Report more than 70% of sales</td>
<td>68</td>
<td>77</td>
<td>80</td>
</tr>
</tbody>
</table>


financial institutions. The crisis also rattled the confidence of Russia’s private sector actors, raising private sector support for a more stable and predictable business environment (Jones Luong and Weinthal 2004). The impetus for institutional reform was cemented by the crafty and popular Putin following his rise to power in 1999.

Tax reforms had a profound impact on the Russian business world. Part I of the new code, which went into effect at the start of 1999, formalized the rights and obligations of taxpayers. It established the presumption of taxpayers’ innocence by placing the burden of proof on the state to provide evidence of unpaid taxes. It also created clearer constraints on tax authorities, such as limiting their right to confiscate bank account funds and curbing the number of allowable inspections per tax period. Part II of the Tax Code, which came into effect in stages beginning in 2001, addressed the specifics of tax rates. The reforms aimed to broaden the tax base by collecting from small- and medium-sized enterprises and citizens. The most drastic reform was the establishment of a flat 13 percent tax on personal income. In 2002 a flat tax of 24 percent on corporate profits was also put in place, slashing tax rates for most firms by more than 10 percent. In 2003 a simplified tax system for small business was created. Meanwhile, a Unified Social Tax streamlined contributions to extra-budgetary funds for pensions and healthcare; in 2005 the Unified Social Tax was reduced from 35.6 to 24 percent in a further effort to reduce firms’ hiding of wages through cash payments — known as paying wages “in envelopes” (v konvertakh). In essence, the reforms created a new social contract. The state would lower tax rates, consolidate the number of taxes, and create a more fair and efficient tax administration; in return firms would pay their dues.

The tax reforms were in many ways a success. As seen in Figure 4.2, tax arrears dropped and tax revenues rose considerably. Debate continues over the extent to which this was due to economic growth, improved tax administration, or increased tax compliance following the
reduction in tax rates (Gorodnichenko et al. 2008; Guriev 2003; Ivanova et al. 2005). Most relevant, however, from the perspective of property security strategies, is that more firms began paying more of their taxes. Table 4.8 shows data from the Business Environment and Enterprise Performance Surveys (BEEPS) conducted by the World Bank and European Bank for Reconstruction and Development. Between 1999 and 2005, the percentage of respondents claiming that a typical Russian firm pays 70 percent or more of their taxes rose from 68 percent to 80 percent, a 12 percent increase; the change was even greater with respect to the percentage of respondents claiming that a typical firm pays 90 percent or more of their taxes — a 23 percent increase. These surveys are not panel data, and so some caution is required in interpreting these changes. But the magnitude of reported change is striking, and respondents, during in-depth interviews conducted by the author, consistently indicated that tax compliance has dramatically improved.

Increased tax compliance and improved tax administration directly transformed property security strategies. First, firms that do not pay taxes are in violation of the law. They thus find it prohibitively risky to use formal legal institutions and are forced to rely on strategies tied to corrupt or private force. Moreover, both criminals and corrupt government officials seek out firms that are in violation of law, knowing that they can be coerced into using illegal protection services. As a Moscow lawyer explained: “In terms of which businesses face problems with bureaucrats and criminal groups, the most vulnerable are those using ‘black cash.’ They can’t turn to the courts or police for help, and everyone knows that” (author interview, 6 February 2009, 060209-L8; also see Hay and Shleifer 1998, 399). Second, a rationalized Tax Code and tax administration gave firms accused of tax violations the basis to resolve the conflict through property security strategies based on law rather than corruption or informal agreements. As noted in Chapter 2, between 2000 and 2008, cases against the tax authorities rose from around 13,000 to over 50,000, a 280 percent increase.

If the hypothesis that tax administration reform contributed to the transformation of property security strategies is correct, then there should be a positive association between tax compliance and property security strategies based on law, as well as a negative association between tax compliance and strategies based on force. In the survey I conducted, firms were asked: “Approximately what percentage of total annual sales would you estimate the typical firm in your area of business reports for tax purposes?” In line with the data from the World Bank-EBRD Business Environment and Enterprise Performance Surveys above, 68 percent of those responding to the question stated that a typical firm reports more than 90

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11 The phrase “black cash” (chernye nalichnye) refers to revenues hidden from state authorities.

12 Data are from Svedeniya o rasmostreennykh sporakh s uchastiem nalogovykh organov [Report on cases with the participation of the tax authorities], which are compiled by the Vyshyi arbitrazhnyi sud [High commercial court].

13 The phrasing a “typical firm in your area of business” is intended to elicit information about the respondent without fear of direct incrimination. The World Bank/EBRD BEEPS surveys pioneered this technique.
percent of tax revenues. In the OLS regressions in Tables 4.9 and 4.10, the primary independent variable of interest is labeled “pay_taxes,” which takes a value of 1 if the respondent believes a typical firm in her line of business reports more than 90 percent of sales revenue for tax purposes and 0 otherwise.\(^{14}\) As in the previous section, the dependent variables are firms’ responses regarding their likeliness of using a given strategy to resolve an asset dispute on a 1 to 7 scale, where 1 indicates that a firm is “highly unlikely” to use a given strategy and 7 indicates “highly likely.”

The findings indicate a robust correlation between tax compliance and property security strategies, even taking into accounting potentially confounding variables such as the age of respondent, gender of respondent, presence of state and foreign shareholder, membership in a business association, firms size (as measured in number of employees), city, and sector. On the 1 to 7 scale of likeliness, tax-paying firms on average rank their likeliness to use lawyers .72 points higher and their likeliness to use courts .89 points higher than non-taxpayers (more than 10 percent of the scale’s total range). The sign of the coefficients for law enforcement and formal reliance on government officials are in the predicted direction but not statistically significant. With respect to force, the results are even more dramatic. The coefficients on the independent variable of interest are highly statistically significant for all strategies. On the 1 to 7 likeliness scale, tax-paying firms’ average ranking of their likeliness to use informal connections in courts, law enforcement officials in a “private” capacity, government officials in a “private” capacity, or criminal rackets are between 1.3 and 1.4 points lower than the average rankings for non-taxpayers (nearly 20 percent of the scale’s total range).\(^{15}\) As in the discussion of ownership consolidation in the previous section, I repeated the analysis using data on firms’ preferred strategies for collecting a debt in place of data on firms’ preferred strategies for resolving an asset conflict. The results were nearly identical.

The results of cross-sectional regression analyses again warrant additional discussion. In particular, the analyses presented here are subject to endogeneity concerns related to reverse causation. Are firms that report paying taxes less likely to use strategies related to force, or are firms that are less likely to use strategies related to force more likely to pay taxes? Nevertheless, the regression results are consistent with the findings that emerge from in-depth interviews, and interview respondents report that tax reforms have been a cause, not an effect, of the shift in property security strategies. The issue deserves further attention, but the available evidence suggests that a rationalized Tax Code, more efficient system of tax collection, and lower rates have allowed firms to improve their tax compliance levels. As a result, the cost to using formal legal institutions relative to force has decreased.

\(^{14}\)The results are robust if a 75 percent threshold is used in place of the 90 percent cutoff.

\(^{15}\)The small N in these regression analyses is due to the high non-response rates on the tax compliance question (44 percent). If we assume that non-responses are more likely to come from firms that report less than 90 percent of sales for tax purposes, then inclusion of the non-responses in the category of low taxpayers only strengthens the results reported in the analyses here.
Table 4.9: Tax Compliance and Use of Law to Resolve Property Conflicts

<table>
<thead>
<tr>
<th>Variable</th>
<th>Lawyers (no connections)</th>
<th>Courts (official capacity)</th>
<th>Bureaucrats (official capacity)</th>
<th>Law Enforcement (official capacity)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept)</td>
<td>5.12 ***</td>
<td>3.63 ***</td>
<td>3.63 ***</td>
<td>4.68 ***</td>
</tr>
<tr>
<td>pay_taxes</td>
<td>0.72 *</td>
<td>0.89 **</td>
<td>0.54</td>
<td>0.48</td>
</tr>
<tr>
<td>log(employee)</td>
<td>0.08</td>
<td>0.04</td>
<td>0.06</td>
<td>-0.05</td>
</tr>
<tr>
<td>age</td>
<td>-0.01</td>
<td>0.17 *</td>
<td>-0.07</td>
<td>-0.04</td>
</tr>
<tr>
<td>gender</td>
<td>-0.14</td>
<td>-0.03</td>
<td>0.37</td>
<td>0.25</td>
</tr>
<tr>
<td>gov_own</td>
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<td>-0.74</td>
<td>-0.64</td>
<td>-1.10</td>
</tr>
<tr>
<td>foreign_own</td>
<td>-0.10</td>
<td>0.66</td>
<td>-1.32 †</td>
<td>-0.58</td>
</tr>
<tr>
<td>bus_assoc</td>
<td>0.06</td>
<td>0.06</td>
<td>0.27 **</td>
<td>0.14</td>
</tr>
<tr>
<td>city dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>sector dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>N</td>
<td>155</td>
<td>155</td>
<td>155</td>
<td>155</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.08</td>
<td>0.12</td>
<td>0.14</td>
<td>0.10</td>
</tr>
<tr>
<td>adj. $R^2$</td>
<td>0.01</td>
<td>0.05</td>
<td>0.08</td>
<td>0.03</td>
</tr>
<tr>
<td>Resid. sd</td>
<td>1.55</td>
<td>1.72</td>
<td>2.02</td>
<td>1.98</td>
</tr>
</tbody>
</table>

Standard errors in parentheses

† significant at $p < .10$; *$p < .05$; **$p < .01$; ***$p < .001$
Table 4.10: Tax Compliance and Use of Force to Resolve Property Conflicts

<table>
<thead>
<tr>
<th></th>
<th>Courts (informal connections)</th>
<th>Bureaucrats (private capacity)</th>
<th>Law Enforcement (private capacity)</th>
<th>Mafia (private capacity)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept)</td>
<td>4.11***</td>
<td>3.69***</td>
<td>3.73***</td>
<td>3.39***</td>
</tr>
<tr>
<td></td>
<td>(1.14)</td>
<td>(0.96)</td>
<td>(1.02)</td>
<td>(0.65)</td>
</tr>
<tr>
<td>pay_taxes</td>
<td>-1.30**</td>
<td>-1.38***</td>
<td>-1.28**</td>
<td>-1.40***</td>
</tr>
<tr>
<td></td>
<td>(0.47)</td>
<td>(0.40)</td>
<td>(0.42)</td>
<td>(0.27)</td>
</tr>
<tr>
<td>log(employees)</td>
<td>0.25 †</td>
<td>0.12</td>
<td>0.12</td>
<td>-0.03</td>
</tr>
<tr>
<td></td>
<td>(0.13)</td>
<td>(0.11)</td>
<td>(0.12)</td>
<td>(0.08)</td>
</tr>
<tr>
<td>age</td>
<td>-0.06</td>
<td>-0.07</td>
<td>-0.04</td>
<td>-0.19**</td>
</tr>
<tr>
<td></td>
<td>(0.10)</td>
<td>(0.09)</td>
<td>(0.09)</td>
<td>(0.06)</td>
</tr>
<tr>
<td>gender</td>
<td>-0.36</td>
<td>-0.12</td>
<td>-0.13</td>
<td>0.27</td>
</tr>
<tr>
<td></td>
<td>(0.43)</td>
<td>(0.36)</td>
<td>(0.38)</td>
<td>(0.25)</td>
</tr>
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<td>gov_own</td>
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<td>0.16</td>
<td>-0.64</td>
<td>0.05</td>
</tr>
<tr>
<td></td>
<td>(0.91)</td>
<td>(0.77)</td>
<td>(0.82)</td>
<td>(0.52)</td>
</tr>
<tr>
<td>foreign_own</td>
<td>-0.15</td>
<td>-0.54</td>
<td>-0.09</td>
<td>0.17</td>
</tr>
<tr>
<td></td>
<td>(0.84)</td>
<td>(0.67)</td>
<td>(0.71)</td>
<td>(0.46)</td>
</tr>
<tr>
<td>bus_assoc</td>
<td>0.05</td>
<td>0.07</td>
<td>0.05</td>
<td>0.13 †</td>
</tr>
<tr>
<td></td>
<td>(0.12)</td>
<td>(0.10)</td>
<td>(0.10)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>city dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>sector dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>N</td>
<td>150</td>
<td>154</td>
<td>154</td>
<td>151</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.11</td>
<td>0.16</td>
<td>0.11</td>
<td>0.32</td>
</tr>
<tr>
<td>adj. $R^2$</td>
<td>0.04</td>
<td>0.09</td>
<td>0.04</td>
<td>0.26</td>
</tr>
<tr>
<td>Resid. sd</td>
<td>2.34</td>
<td>1.99</td>
<td>2.11</td>
<td>1.36</td>
</tr>
</tbody>
</table>

Standard errors in parentheses

† significant at $p < .10$; *$p < .05$; **$p < .01$; ***$p < .001$
4.2.2 Development of the Banking Sector

In the 1990s, firms rarely relied on the banking sector. They conducted transactions primarily in cash. To the extent that investment occurred during this recessionary period, firms relied on retained earnings rather than bank financing. It was not until the banking sector developed in the early 2000s that transactions began to flow through the banking system and firms began to seek loans. Bank transactions raised the cost of illegal property security strategies by creating a paper trail that made illicit strategies more risky and difficult to conceal. Meanwhile, the vetting undergone by banks in order to receive loans further encouraged firms to avoid force.

The banking system that emerged from the Soviet command economy was poorly equipped for financing a modern market economy. As the Soviet Union collapsed and private enterprise became legal, the number of banks skyrocketed, reaching more than 2400 by 1994, far above the OECD average (OECD 2009, 99). Yet few of these banks performed the legitimate role of financial institutions. Banks instead functioned like corporate treasuries for financial industrial groups (FIGs) or other large companies, which in a low-trust environment sought to avoid arms-length transactions with outside financial institutions. Since banks had the right to deal in foreign exchange, FIGs also valued them as a tool to move capital abroad or launder money. Despite the large number of banks, a handful of institutions dominated the banking system. In the late 1990s, approximately two-thirds of all banking assets belonged to just 30 banks; four-fifths of all banking assets were located in Moscow-based institutions. As seen in Table 4.11, loans to enterprises were almost non-existent, particularly for small businesses. Supervision and regulation of the banking system was highly inadequate, and complicated by the continued use of the Russian Accounting System rather than the International Accounting System, with its more rigorous disclosure requirements (Chowdhury 2003; OECD 2009, 99-100).

Banks during this period rarely served as intermediaries between holders of capital and enterprises in need of financing. Instead, they engaged in speculative activity, including large purchases of short-term government bonds, known as GKO$s, the interest on which rose to phenomenal heights — over 250 percent — prior to the 1998 government revenue crisis discussed above. With over one-third of bank assets tied up in claims on government debt, and another one-fifth of liabilities in foreign denominations that were inflated away following Russia’s currency devaluation, the 1998 financial crisis wreaked havoc on the financial system. The collapse accelerated the consolidation of the banking sector that was already underway (Barisitz 2009, 48).

The economic growth that followed the crisis reinvigorated the financial sector. By the early 2000s, capital-starved firms were seeking loans in order to maintain their rapid pace of expansion. At the same time, opportunities for speculative activity based on hyperinflation, short-term bonds, and privatization auctions dried up. Between 2003 and 2005, a series
Table 4.11: Bank Transactions, Deposits, and Loans, 1999-2008

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of transactions conducted through the Russian payment system (millions)</td>
<td>--</td>
<td>--</td>
<td>63</td>
<td>738</td>
<td>855</td>
<td>992</td>
<td>1117</td>
<td>1673</td>
<td>2456</td>
<td>2782</td>
</tr>
<tr>
<td>Deposits by non-financial enterprises (% of GDP)</td>
<td>1.3</td>
<td>1.6</td>
<td>2.4</td>
<td>2.3</td>
<td>2.1</td>
<td>1.8</td>
<td>2.6</td>
<td>3.5</td>
<td>4.7</td>
<td>8.5</td>
</tr>
<tr>
<td>Credits extended to non-financial enterprises (% of GDP)</td>
<td>9.9</td>
<td>11.0</td>
<td>13.7</td>
<td>15.3</td>
<td>18.0</td>
<td>19.2</td>
<td>19.7</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
</tbody>
</table>

Sources: Data for transactions and deposits from Bank of Russia’s Bulletin of Bank Statistics, various years. Data on credits for 1998-1999 are from Tompson (2004, 6) and for 2000-2005 are from Noel et al. (2006, 28).

of banking reforms further contributed to the development of the sector. The government created deposit insurance, increased the capital adequacy ratio and minimum capital requirements, introduced a plan for a mandatory transition to the International Accounting Standard, developed a simplified lending system for small businesses, and amended the Law on Banks and Banking Activity and the Law on the Bank of Russia so as to improve the regulatory environment (Barisitz 2009, 52-53; Chowdury 2003; Tompson 2004).

As seen in Table 4.11, firms recognized the growing stability and trustworthiness of the banking system and began to utilize bank transactions and seek bank loans. Simultaneously, the government, in an effort to reduce tax evasion, took steps to require all companies to open bank accounts and introduced mandates that all large transactions take place through the banking system. During this period, owners of firms began to perceive the unwillingness of a potential business partner to conduct business via bank transactions as a sign of crookedness and to restrict dealings with such firms (author interview, 9 February 2009, 020909-F1). Exclusion of firms preferring to deal only in cash transactions provided additional incentives to rely on the banking system.

Firms’ growing reliance on the banking system transformed property security strategies in multiple ways. First, when nearly all transactions were done in cash, it was relatively easy to allocate resources for the types of tactics described in Chapter 2, such as bribing a government official to raid a competitor, or hiring thugs and contract killers to settle a conflict. By contrast, when transactions are done through the banking system, it leaves a paper trail that raises the costs and risks of using force. It is possible to conceal this trail through front companies, slush funds, and other creative endeavors, but this requires
additional time and expenses (author interview, 9 February 2009, 020909-F1). The shift in relative costs thus makes property security strategies based on law more appealing. Second, when firms rely on bank loans, or even seek to open a bank account, an extra system of vetting is introduced. For example, a manager at a mail-order business based in Moscow related an incident where a representative of his company who had been sent to open a bank account appeared to be concealing information. His request was denied. Within hours, their company had been blacklisted by banks throughout Moscow (author interview, 11 March 2009, 030109-F9).

To examine the hypothesis that development of the banking system reduces firms’ reliance on property security strategies based on force, I conducted two sets of analyses. As in previous sections, the analyses use the scenario regarding firms’ preferred strategies for resolving an asset conflict. First, I compared firms that rely heavily on cash transactions to those which do not. In the survey I conducted, respondents were asked: “Approximately what percentage of your firms’ transactions were done in cash?” Fifty percent of firms reported that they conduct less than 10 percent of transactions in cash, and I label these “low-cash” firms. As seen in Table 4.12, the evidence is again consistent with the hypothesis. “Low-cash” firms on average rate their likeliness to use courts with informal connections approximately 1 point lower than firms that conduct more than 10 percent of their transactions in cash, and they rate their likeliness to use law enforcement in an unofficial capacity approximately .75 points lower. The sign of the coefficient on the use of government officials in an unofficial capacity is in the expected direction, but the results are not statistically significant. These results are again robust to the inclusion of a wide range of potentially confounding variables.

Second, I examined the relationship between bank loans and property security strategies. I compared firms that received a bank loan in the last three years or expect to receive a bank loan in the next three years to those who have not received and do not expect to receive bank financing. Thirty-five percent of firms in the sample have recently relied on or expect to rely on bank loans. Some evidence in support of the hypothesis that bank loans encourage law-based property security strategies emerges, but the association holds only for the sub-sample of firms located in Moscow. For Moscow-based enterprises, firms that rely on bank financing report a higher likeliness of using courts, law enforcement officials, and lawyers to resolve the asset conflict out of court, and the distinction is statistically significant. The findings (not shown here) are robust in multiple regressions to the inclusion of control variables for firm size and sector, but due to the small size of the sub-sample, it is difficult to include additional controls. That the effect of bank loans is limited to Moscow might be due to the fact that until very recently, financial institutions were concentrated in the capital. Financial institutions in the capital therefore might have a greater ability to conduct risk analyses, vet borrowers, and carry out due diligence, but further research is necessary to confirm this hypothesis.

16 The results are robust if a 25 percent threshold is used in place of the 10 percent cutoff.
Table 4.12: Cash Transactions and Use of Force to Resolve Property Conflicts

<table>
<thead>
<tr>
<th>OLS Regressions</th>
<th>Courts (informal connections)</th>
<th>Bureaucrats (private capacity)</th>
<th>Law Enforcement (private capacity)</th>
<th>Mafia</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept)</td>
<td>3.68 ***</td>
<td>3.02 ***</td>
<td>3.37 ***</td>
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Standard errors in parentheses

† significant at $p < .10$; *$p < .05$; **$p < .01$; ***$p < .001$
In summary, development of the banking sector has contributed to the shift from force to law. As firms have turned away from cash transactions, the cost of using illegal property security strategies has risen. Meanwhile, the increasing reliance on bank loans, at least among Moscow firms, also provided a stimulus for the use of strategies based on law.

4.3 International factors

Institutional formation in the West was primarily a domestic phenomenon, driven by internal socioeconomic changes and the clash of domestic interest groups. By contrast, in today’s globalized world, international forces play a significant role in the institutional development of transition and developing countries. In Russia, the quest for external finance, such as foreign direct investment (FDI) or initial public offerings (IPOs) on foreign exchanges, created pressures for firms to avoid illegal property security strategies. Multinational companies (MNCs) operating within Russia instilled new business practices in Russian employees, who then spread these practices as they moved on to become managers at large Russian firms or to found start-up companies. International law and accounting firms hired and trained young Russians, thereby creating a domestic supply of high-quality lawyers and auditors. Finally, in recent years, Russia’s largest firms have expanded into foreign markets, acquiring assets abroad. This has placed an even higher premium on their image and further raised the costs and risks of using illegal property security strategies.

As discussed above, in the 1990s managers and owners of Russian firms were primarily focused on short-term control of financial flows, asset stripping, or the rapid acquisition of additional assets via the privatization process or other ties to the state. In this environment, demand for investment capital was limited and firms were able to satiate what demand there was through retained earnings or government subsidies. Given the rough tactics employed in business, foreign investment was limited to large, powerful players such as McDonald’s, Mars, Inc., and ExxonMobil, who believed they had the clout and resources to protect their assets using government connections or private security.

The economic growth unleashed after the 1998 crisis transformed Russian firms’ demand for external financing, and they soon exhausted the limits of the domestic financial system. Firms began to seek strategic foreign direct investors. Table 4.13 shows the increase in FDI throughout the 2000s. In 2008, it reached 75 billion dollars — the sixth largest inflow of FDI in the world and second only to China among developing countries.17 In addition to FDI, Russian firms turned to Eurobonds and loans from foreign banks. By 1998, Russia’s private

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17 Data are from the World Bank’s World Development Indicators, available at www.data.worldbank.org. For a discussion of different measures of FDI into Russia, see Pappe and Golukhina (2009, 116-117).
CHAPTER 4. TRANSFORMING INCENTIVES

Table 4.13: Reliance on Foreign Finance

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*PNG = private non-guaranteed
**Includes Russian companies registered offshore

Sources: Data for IPOs provided by Yurii Danilov, Director of the Center for Capital Market Development Foundation in Moscow, in response to author’s correspondence (see also Danilov and Yakushin 2009); other data are from the World Bank’s World Development Indicators, www.data.worldbank.com.

sector had accumulated a larger external debt than that of any other developing country.\(^{18}\)

As the forerunners of bank financing accumulated debt, low-interest loans became harder to acquire, which raised the appeal of IPOs. In 2004 Russian firms conducted only five IPOs, which raised a total of less than one billion dollars. By 2006, Russia was among the top five countries in terms of funds raised through IPOs, a trend that continued into 2007. Many of these IPOs occurred on the London Stock Exchange (30 in 2007), and a handful of other firms were listed on the New York Stock Exchange (8 in 2007). Offerings on Russia’s domestic exchanges also attracted significant involvement among foreign investors (Pappe and Galukhina 2009, 113-114).

There are numerous ways in which foreign finance created incentives for firms to change property security strategies. First, the need for external resources provides companies with an incentive to improve their image, for fear that a reputation for illicit behavior could drive away potential investors. This factor is arguably even more pertinent for large Russian companies investing abroad, as an unsavory reputation may make foreign sellers hesitant to conduct business or lead to objections from host governments. As the head of government relations for the foreign operations of a major Russian metal company explained: “If you’re Gazprom, and selling gas is all you do, then image is not important. If you’re like us, with a headquarters in London, and the only way to expand is by buying companies abroad, then you better focus on your image” (author interview, 10 June 2009, 061009-F27).

\(^{18}\)As measured in private nonguaranteed external debt stocks. Data are from the World Bank World Development Indicators dataset.
Factors other than reputation play an important role in changing property security strategies once investment has occurred, particularly in the case of FDI. When large MNCs invest in assets in countries such as Russia, they seek to limit employee theft, prevent asset stripping, improve top-level executives’ authority over lower-level managers, and increase oversight of subsidiaries. Control and oversight of subsidiaries and lower-level managers is particularly important for MNCs subject to anti-corruption legislation in their home countries, such as the U.S. Foreign Corrupt Practices Act or the OECD Convention on Combating Bribery of Public Officials in International Business Transactions. Consequently, following investments, large MNCs standardize accounting, human resource, and compliance procedures. In the words of a Russian finance director with experience working in MNCs operating in Russia’s pharmaceutical sector: “There are three main reasons why Western companies choose to work legally: (1) the company’s image; (2) clearly elaborated procedures; and (3) even if you want to speed up some process, the shareholders don’t especially value this, but if there is a [legal] violation, then the penalty is large. There’s no sense in risking this” (author interview, 8 December 2009, 120809-F41). These principles limit the discretion of lower-level managers to utilize illegal property security strategies.

Furthermore, as part of their effort to monitor cash flow and prevent employee theft and asset stripping, MNCs also seek to eliminate cash operations. For example, when a large Western aluminum company invested in a Russian facility, it learned that the Russian plant had continued to operate a wood chip business inherited from Soviet times, receiving payments in off-the-books cash or barter. Upon acquisition by foreign owners, the side business was immediately shut down (author interview, 14 March 2009, 031409-F10). As discussed in the preceding section on development of the banking sector, constraints on off-the-books cash raises the costs and complexity of financing property security strategies that violate the law.

Finally, FDI and IPOs require significant legal and accounting services, which attracts international firms. Already by 2000, before the significant expansion of foreign financing, Moscow had become a major hub for global law firms, nearly on par with major European and Asian capitals (Faulconbridge et al. 2008). These firms trained young Russian lawyers, many of whom by the mid-2000s were working for top Russian firms or starting their own practices. According to a former Russian employee of Ernst and Young, who now works in the finance department of a major Russian oligarch’s holding company, the surge in IPOs had a similar effect on the next generation of Russian accountants and auditors, many of whom found employment with Big Four Accounting during the height of the IPO period and then moved on to work for domestic companies (author interview, 26 February 2009, 022609-F5).

Naturally, there are limits to the effect of international financing on property security strategies. Some changes in corporate behavior were largely cosmetic. As a longtime European consultant in Moscow noted, in the early 2000s Russian companies conducted corporate governance reforms “just up to the point needed to get investment” (author interview, 20
March 2009, 032909-F11). Moreover, the direct effect of IPOs and to a lesser extent FDI has been limited to large companies. Nonetheless, the impact of international influences spread beyond the initial recipients of foreign investment via spillover effects. Small businesses working as suppliers to MNCs note fundamental differences between foreign and domestic clients’ effort to comply with laws. For example, a local manufacturer of industrial uniforms in Moscow emphasized that in contrast to many large Russian firms, MNCs do not expect kickbacks from smaller companies seeking to become part of their supply chain (author interview, 13 October 2009, 101309-F28). The scope of MNCs’ influence can be extensive. In 2010, McDonald’s reported 25,000 Russian employees, but the Russian companies in its supply chain employed an additional 100,000 people (Kramer 2010).

Spillover effects also occur as MNCs transform the mentality of Russian employees. For instance, a 2007 study commissioned by the American Chamber of Commerce in Russia compared the opinions of Russian employees in large American-owned firms to Russian employees in Russian-owned firms. In American-owned firms, 100 percent of respondents agreed with the statement, “The company aims to strictly obey Russian legislation.” The corresponding number for Russian-owned companies was 78 percent. As one employee of an American firm explained, “Since the moment I came here, I have never received money in an envelope. I realized what the organization was trying to tell me: ‘We live according to Russian legislation.’ This became crystal clear right away” (American Chamber 2007). Employees with experience working in MNCs are in high demand, and as they move on to work for Russian firms, they potentially bring along newly ingrained practices and mentalities.

During in-depth interviews, the influence of international investment was the most discussed explanatory factor accounting for the transformation of Russian firms’ property security strategies, particularly among representatives of larger enterprises. Of 49 firms interviewed, 17 had over 250 employees. Of these, 9 respondents raised the issue of demand for external finance — without prompting — when asked about the factors contributing to the evolution of firms’ strategies for protecting assets. Unfortunately, subjecting the hypothesis that demand for external finance reduces firms’ use of illegal strategies to further testing is challenging due to data limitations. Sample frames for firms with foreign ownership are not readily available, and in my survey, only 11 percent of firms report having a foreign owner with a stake of 10 percent or larger. Only 5 percent of respondents report having received FDI in the last three years or expecting to receive FDI in the next three years. Even fewer firms in the sample — 3 percent — have conducted or expect to conduct an IPO. Comparing the property security strategies of firms that rely on FDI or that have conducted an IPO with other firms in the sample produces no statistically significant findings, but this may be due to the small size of the sub-sample receiving foreign financing.

Other factors might also undermine the expected results. Foreign ownership is usually measured as a foreign shareholder with more than 10 percent of shares, and this is the measure used in my survey. However, some studies of the impact of FDI on enterprise restructuring
and productivity find that 10 percent ownership is not sufficient to change firm behavior. Rather, a majority stake is needed, and a similar ownership stake might be necessary to change firms’ behavior with respect to property security strategies as well (Yudaeva et al. 2000). A final issue is that data on foreign investment in Russia often includes inflows of capital that Russians themselves are reinvesting following the massive capital flight that took place during the chaos of the 1990s. A thorough analysis of the effects of foreign financing on property security strategies may require attention to distinctions between genuine foreign investment and repatriated investment.

While confirmation of the findings from in-depth interviews will require the collection of additional survey data, the existing evidence indicates that foreign financing has played a significant role in the transformation of property security strategies. Russian firms’ reliance on external finance has increased considerably. There are clearly identifiable mechanisms whereby this increase affects firms’ strategies for protecting assets, and Russia’s private sector actors themselves consistently indicate their belief that foreign financing has contributed to the shift from force to law.

4.4 Conclusion

An incentive transformation has driven the shift in Russian firms’ property security strategies. The relative cost of using force has increased, while the relative benefits from using force have declined. Simultaneously, the relative cost of using law has decreased, while the relative benefits from using law have risen. Drawing on interviews with firms, lawyers, and private security agencies, this chapter has illustrated these shifts through analysis of several factors that have had a particularly significant impact on firms’ strategies. The transformation of ownership structures played a especially important role. Once they consolidated their stakes in privatized firms, owners began to focus on longer-term investments. This longer-term perspective placed a higher value on stability and reputation, which raised the costs of using property security strategies based on force. Meanwhile, the expansion of modern shopping centers, business centers, and retail chains provided firms with new forms of security. The transformation of places where people work and shop reduced the relative value of private force and informal connections, while also placing constraints on lower-level managers’ ability to resort to coercion and corruption.

Institutional changes such as tax administration reform and the development of the banking sector have similarly contributed to firms’ switch from force toward law. Improvements in the tax system reduced firms’ legal violations, allowing them to utilize formal institutions without fear of scrutiny. The relative cost of strategies based on law declined. Meanwhile, the switch from cash to banking transactions created new constraints on the use of force to protect assets. Finally, the transformations underway in Russia are taking place in the
context of a global economy. The need for foreign financing has increased the risk of using illegal property security strategies, as Russian firms have begun to consider the effects of a tarnished reputation on their investment prospects.

Naturally, these broad trends have not affected all firms equally. In addition to the shift in incentive structures over time, there is significant variation in the incentive structures across different types of firms. Variation across private sector actors’ property security strategies is the subject of the next chapter.
Chapter 5

Who Uses Law?

The previous chapter offered insights into the factors contributing to the transformation of Russian firms’ property security strategies. These factors do not, of course, affect all firms equally. The consolidation of ownership primarily concerns privatized firms. Levels of foreign investment vary across different sectors. Yet beyond these lines of division, there are fundamental differences between different types of firms’ property security strategies. Examination of such variation provides valuable information about which types of firms are likely to serve as a pro-reform constituency that supports institutional development.

Variation across firms’ property security strategies derives from their differing incentives, not because the owners and managers of some firms hold a deeper normative conviction in the importance of law. As discussed in Chapter 3, the development of law and formal legal institutions imposes both benefits and constraints on enterprises. This is true for all firms, but the balance of these benefits and constraints differs according to enterprises’ characteristics. Two factors are of particular importance: (1) the types of threats and challenges firms face and (2) the resources for protecting assets at firms’ disposal.

This chapter examines distinctions among different types of enterprises in greater detail with a focus on some crucial characteristics of firms that affect challenges and resources. First, firms of different sizes, from different sectors, and operating in different types of markets face distinct threats and have access to particular sources of asset protection. Although existing research predicts that demand for law should emerge among the small business sector, my findings reveal a curvilinear relationship between firm size and property security strategies: Medium-sized firms appear more likely to rely on law than either small or large firms. Meanwhile, firms that deal in the production or distribution of physical products — as opposed to the provision of services — face more direct and concrete threats to their assets, and therefore derive greater value from a widespread shift from force to law. Finally, firms that operate in local as opposed to national markets are more likely to rely on informal
connections and corruption.

A second factor that leads to variation across firms with respect to threats and resources pertains to “relational assets” — the types of people and organizations with whom a firm regularly interacts. After all, the resources required to use force — particularly informal connections with government officials — are not equally available to all firms. Informal services are for sale, but not on an open market. Because of the corrupt nature of the transaction, the trust that evolves out of long-standing and personal relationships is particularly important. Firms that have regular contact with people who can provide, or introduce them to people who can provide, such services are more likely to use them. Relational assets develop in a variety of ways: sales to clients, purchases from suppliers, or regular interaction with government regulators. Consequently, a firm’s market position vis-à-vis distinct types of customers, suppliers, and government officials affects its property security strategies.

Third, there are certain foundational moments in the life cycle of a firm and foundational points within firms’ supply chains that affect all subsequent threats and resources. If a certain type of permit is nearly impossible to obtain legally, then a firm that relies on such a permit may struggle to operate legally and may be forced to avoid formal institutions for fear of scrutiny. If imports cannot be conducted without legal violations, then the range of strategies for addressing conflicts during downstream transactions may be more limited. Identifying such choke points is thus essential for understanding variation in property security strategies across firms.

These three issues may at times be intertwined. Crucially, in addition to the direct relationship between firm size and property security strategies, firm size interacts with other factors that affect firms’ utilization of strategies for protecting assets. For example, small firms with minimal informal connections may be more sensitive to the presence of relational assets that offer access to new resources. This chapter therefore examines the issues of firm size, relational assets, and foundational moments both as distinct sources of variation across firms and as interacting phenomena.

5.1 Size, Sector, and Markets: Distinct Threats and Resources

5.1.1 Firm Size

The most significant source of variation in firms’ property security strategies pertains to firm size. Firms of different sizes face distinct challenges and have distinct resources at their disposal. Existing studies have recognized the importance of firm size for institutional development. Usually their focus has been on small businesses. For example, Åslund and
Johnson (2004) introduce a policy paper on the role of small businesses in post-communist countries as follows:

Institutions such as strong property rights and the rule of law are important for both long-run economic performance and short-run volatility. Developing good institutions is generally viewed as a desirable goal, but there is no agreed road map for such changes. This paper suggests that, at least for former communist countries, the right way to begin is by lowering the barriers to entry into the formal sector for small-scale entrepreneurs. These policies have economic advantages, but their most important effect is to change the political equilibrium, creating a powerful force for further institutional improvement.

Jackson et al. (2003) and Frye (2003) similarly suggest that start-up firms are the social foundation of pro-reform constituencies which support the development not only of markets, but also of democracy in the post-communist region.

Yet it is not clear that small firms should be the natural constituency for — and large firms a natural constituency against — institutional development. The notion that small firms benefit disproportionately from institutional development stems from the idea that in a lawless environment, larger firms are better equipped to protect themselves privately while expropriating assets of smaller firms (Polishchuk and Savateev 2004; Sonin 2003). However, both large and small firms face conflicting incentives. Small firms disproportionately benefit from a widespread shift in property security strategies from force to law, but they themselves lack resources to be frontrunners in such a transformation. Large firms, on the other hand, benefit disproportionately from maintaining an environment in which the use of force is widespread, yet they also have resources at their disposal to adapt to a law-based environment and face reputational concerns that provide additional incentives to avoid the use of force.

The benefits and constraints firms encounter during a shift from force to law are numerous and complex, and they affect large and small firms in different ways. First, reliance on law requires that firms pay taxes, an issue examined at length in the previous chapter. Small firms are less likely to pay their full share of taxes and operate fully in the formal sector. For example, in the survey I conducted, 65 percent of firms with less than 500 employees responded that they report 90 percent or more of their sales revenue for tax purposes; the corresponding figure for firms with more than 500 employees was 78 percent. An even greater distinction appears when considering the extent to which firms report payroll expenses for tax purposes. Only 45 percent of firms with under 100 employees claim to report 90 percent or more of their payroll expenses for tax purposes; 58 percent of medium-sized and large firms (between 101 and 500 employees) claim to report 90 percent or more. By contrast, for very large firms (more than 500 employees) the corresponding figure was 68 percent.

Second, the resources required for compliance with formal rules and regulations may present an insurmountable burden to smaller firms, given that they face greater resource constraints.
than larger firms. Third, while it is true that large firms may have a relative advantage in resources for the use of force, they often possess a similar relative advantage in legal resources. Moreover, in many cases, the resources underlying an advantage in coercion and corruption can be redeployed to create an advantage in court. Finally, reputational effects provide stronger incentives for large firms than for smaller firms to switch from force to law. Larger firms are the ones most concerned with building a durable brand. Additionally, large firms are the ones most in need of international financing, and the use of force risks driving away external investors. Consequently, as a Russian finance director with experience in several large pharmaceutical companies explained, “Over the last 15 years, we can, of course, talk about some serious changes. Now, many large companies are run according to the principle: Why soil your name if it’s possible to do things legally?” (author interview, 3 December 2009, 120309-F41).

In contrast to the conflicting incentives faced by large and small firms, medium-sized firms find an unambiguous advantage in the use of law-based property security strategies. As explained in detail by a consultant specializing in the development of consumer markets in Russia’s regions:

When a business reaches a medium size, then stable rules of the game are important. Small business doesn’t need such rules, because, to put it lightly, small businesses aren’t very stable....[Medium-sized businesses] have good capitalization but their after-tax profits are only 1.5 to 2 percent. And if we consider the “human factor,” then this 1.5 percent can be lost to employee theft.... Therefore, medium-sized businesses are forced to do things legally, so that when they catch a dishonest accountant stealing, they aren’t afraid to go to court because their bookkeeping is clean.... As concerns big business, unfortunately, [Russian] companies all have offshore [ownership] structures, and the “KGB,” despite much discussion, still hasn’t established rules of the game for them (author interview, 26 March 2009, 032609-F15).

The head of an IT software company in Moscow concurred that medium-sized firms have sufficient resources to aim for compliance with laws and regulations, unlike small firms. Yet unlike large firms, their operations are not so sizeable as to require the development of costly and complex ownership structures involving multiple legal entities, the creation of which often entails semi-legal regulatory shortcuts (author interview, 23 November 2009, 112309-F34). Meanwhile, with respect to conflicts with tax authorities, medium-sized firms are too large to stay out of sight, unlike smaller firms, yet they do not possess the political clout or informal connections that large firms can utilize to reduce their tax burden (Shleifer and Treisman 2001, ch. 7). Their best option is to comply with tax legislation; this improved compliance with the law encourages them to rely on resources such as courts and other

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1 This is a reference to Putin, himself a former KGB officer, and his associates from the intelligence services.
formal institutions when conflicts arise.

Data on property security strategies offer support for the hypothesis that medium-sized firms should be more likely than small or large firms to rely on law rather than force. As in previous chapters, I analyze respondents’ rankings of their preferred strategies for resolving and asset conflict on a 1 to 7 scale, where 1 means “highly unlikely” and 7 means “highly likely.” In line with the prediction of a curvilinear relationship between firm size and property security strategies, medium-sized firms have a higher reported likeliness of turning to lawyers to resolve the dispute out of court, filing a claim in court, or turning to bureaucrats in an official capacity than either small or large firms. Figure 5.1 demonstrates that firms’ reported likeliness to use strategies based on law rises with firm size, peaks for the firms with between 250 and 500 employees, and then falls again for firms with over 500 employees. A similar pattern emerges for analysis of firms’ preferred strategies for collecting a debt: Medium-sized firms are most likely to rely on property security strategies based in law.2

Further evidence of mid-sized firms’ demand for law emerges when considering the extent to which firms value institutional development. In the survey I conducted, respondents were requested to rank the importance (on a 1 to 7 scale, where 1 is “not at all important” and 7 is “very important”) of the following institutions for the success of their business: an effective and non-corrupt police force, effective and non-corrupt commercial courts, effective and non-corrupt bureaucrats and inspectors, and an effective, pro-business president. As shown in Figure 5.2, a pattern similar to that of firms’ use of property security strategies appears. Mid-sized firms value institutional development to a greater degree than both small firms and large firms.

In summary, legal institutions place benefits and constraints on all firms, creating countervailing incentives for the use of force and the use of law. But the balance of these incentives differs for firms of different sizes. Resource constraints limit small firms’ reliance on law, even though they benefit disproportionately from a widespread shift to law-abiding behavior. Large firms possess the necessary resources to lead a shift to property security strategies rooted in law, but they may perceive an advantage in the use of force. Medium-sized firms have both the necessary incentives and resources to switch from force to law.

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2 To confirm that the correlation between firm size and property security strategies is not spurious, I conducted multiple regression analyses including a quadratic and cubic term for firm size (measured in number of employees) along with control variables for age of respondent, gender of respondent, presence of state and foreign shareholders, membership in a business association, and dummy variables for city and sector. The results are robust for all strategies except law enforcement.
Figure 5.1: Firm Size and the Use of Law to Resolve Property Conflict

Average responses on a scale of 1 to 7, where 1 is “very unlikely” and 7 is “very likely”

Respondents were asked the following question: *Let’s say that a competitor is trying to gain control of some significant physical asset owned by your firm (e.g., office space or a factory). To defend its assets, how likely would a firm like yours be to do each of the following?*

Figure 5.2: Firm Size and the Value of Good Institutions

Average responses on a scale of 1 to 7, where 1 is “not at all important” and 7 is “very important”

Respondents were asked to rate the importance of effective and non-corrupt institutions, such as those shown in Figure 5.2, for the success of their business.
5.1.2 Firm Sector

Like firm size, sectoral distinctions are a source of variation across firms’ property security strategies. The challenges firms face depend on the type of output they produce. Unscrupulous competitors or government officials can directly expropriate physical products or the assets used to manufacture them. Firms that produce a physical product therefore perceive a direct, concrete threat to their assets. On the other hand, expropriation of a service firm’s assets is more difficult, given that service firms create value through relationships with customers or high-quality management of employees’ skills and knowledge. As a head of a small logistics consulting firm in Moscow explained:

[Difficulties] also depend a little bit on the industry. For example, the service industry: If these [new entrepreneurs] would set up a small restaurant or a small food production plant or a small “old economy” type of business, they would have much more trouble than if they set up their own small PR agency. There’s a big difference. There’s no one from the authorities, no one from the fire brigade, no one from the police that is going to come [to my] company and tell me that my fire exit is not all right. Because they don’t understand what I’m doing… Even if I would have a raid by the tax police right now, I would say [to my employees], okay guys, we all move to my apartment. [The authorities] would take the computers, well, tough luck. We lose the files, but, okay, what we sell is in here [points to his head]. And that is a big difference (author interview, 20 March 2009, 032009-F11).

Consequently, firms that produce a physical product feel more vulnerable in an environment where force is rife, and they place greater value on the development of legal institutions and law-based property security strategies.

Table 5.1 provides insights into variation across sectors. Of the survey sample, 44 percent of respondents describe their firm’s main output as a physical product, 54 percent as a service, and 2 percent as intellectual property. (Given the small size of the intellectual property sub-sample, I focus on distinctions between the former two categories). Of firms producing a physical product, 78 percent report having experienced a violation of their legal rights over the last three years, whereas only 56 percent of firms offering services report such a violation. Correspondingly, approximately 86 percent of firms that produce or distribute a physical product agree with the statement, “An effective legal system makes my assets safer,” compared to 73 percent of service firms.

These distinct threats and incentives translate into distinct approaches to the protection of assets. Tables 5.2(a) and 5.2(b) show variation between the property security strategies of service firms and firms that produce a physical product. Service firms report being less likely to turn to the commercial courts or to rely on lawyers to settle the dispute out of court. They
Table 5.1: Threats and Perceived Need for Legal Protection, by Type of Output

<table>
<thead>
<tr>
<th></th>
<th>Physical Product</th>
<th>Services</th>
<th>T-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>% of Firms Experiencing Rights Violation (in last three years)</td>
<td>78.1 (128, 3.67)</td>
<td>55.8 (156, 3.99)</td>
<td>4.13***</td>
</tr>
<tr>
<td>% of Firms Agreeing with the Statement: “An effective legal system makes my assets safer”</td>
<td>85.8 (127, 3.11)</td>
<td>73.3 (161, 3.50)</td>
<td>2.68**</td>
</tr>
</tbody>
</table>

Note: Number of observations and standard errors in parentheses

*p < .05; **p < .01; ***p < .001

also report being less likely to seek the assistance of government officials or law enforcement agencies acting in their official capacity. On the other hand, service firms report being more likely to seek the assistance of government officials or law enforcement agencies acting in a private capacity, such as the protection rackets run by state officials discussed Chapter 2. They also report being more likely to utilize the services of criminal protection rackets.

As Table 5.2 shows, nearly all of the distinctions between service firms and firms producing or distributing physical products are statistically significant at conventional levels in difference-of-means tests. The findings are also largely robust using multiple regression analyses to control for potentially confounding factors. Moreover, as with firm size, the sectoral variation pertaining to preferred strategies for addressing an asset struggle also appears with respect to preferred strategies for collecting a debt. Firms whose primary output is a physical product report being more likely to use the court system to end a conflict with a debtor; service firms report being more likely to use government officials or law enforcement agencies acting in a private, unofficial capacity. Comparison of sectoral differences thus offers further support for the idea that property security strategies vary in accordance with the threats firms face and resources at their disposal.

With the exception of turning to the commercial courts, the statistically significant sectoral differences presented in Table 5.2(a) remain robust using multiple regression analyses with control variables for firm size, foreign or government ownership stakes, the age and gender of the respondent, and dummy variables for cities. The statistically significant sectoral differences presented in Table 5.2(b) are similarly robust to the inclusion of these control variables, with the exception of turning to a criminal protection racket.
CHAPTER 5. WHO USES LAW?

Table 5.2: Sectoral Variation and Property Security Strategies

Average responses on a scale of 1 to 7, where 1 is “very unlikely” and 7 is “very likely”

(a) Type of Output and Use of Law to Resolve Property Conflicts

<table>
<thead>
<tr>
<th>Type of Output</th>
<th>Physical Product</th>
<th>Services</th>
<th>T-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lawyers</td>
<td>6.19</td>
<td>5.92</td>
<td>1.55</td>
</tr>
<tr>
<td></td>
<td>(130, 0.13)</td>
<td>(162, 0.12)</td>
<td></td>
</tr>
<tr>
<td>Courts</td>
<td>5.98</td>
<td>5.46</td>
<td>2.51*</td>
</tr>
<tr>
<td>(without connections)</td>
<td>(129, 0.14)</td>
<td>(159, 0.15)</td>
<td></td>
</tr>
<tr>
<td>Bureaucrats</td>
<td>4.87</td>
<td>4.34</td>
<td>2.10*</td>
</tr>
<tr>
<td>(in official capacity)</td>
<td>(125, 0.19)</td>
<td>(160, 0.17)</td>
<td></td>
</tr>
<tr>
<td>Law Enforcement</td>
<td>5.38</td>
<td>4.99</td>
<td>1.70†</td>
</tr>
<tr>
<td>(in official capacity)</td>
<td>(128, 0.17)</td>
<td>(162, 0.16)</td>
<td></td>
</tr>
</tbody>
</table>

(b) Type of Output and Use of Force to Resolve Property Conflicts

<table>
<thead>
<tr>
<th>Type of Output</th>
<th>Physical Product</th>
<th>Services</th>
<th>T-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Courts</td>
<td>4.35</td>
<td>4.34</td>
<td>.04</td>
</tr>
<tr>
<td>(with informal connections)</td>
<td>(115, 0.21)</td>
<td>(148, 0.19)</td>
<td></td>
</tr>
<tr>
<td>Bureaucrats</td>
<td>3.29</td>
<td>3.96</td>
<td>-2.59*</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(122, 0.18)</td>
<td>(154, 0.18)</td>
<td></td>
</tr>
<tr>
<td>Law Enforcement</td>
<td>3.46</td>
<td>4.07</td>
<td>-2.33*</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(120, 0.19)</td>
<td>(155, 0.18)</td>
<td></td>
</tr>
<tr>
<td>Mafia</td>
<td>1.63</td>
<td>2.07</td>
<td>-2.33*</td>
</tr>
<tr>
<td></td>
<td>(119, 0.12)</td>
<td>(148, 0.14)</td>
<td></td>
</tr>
</tbody>
</table>

Note: Number of observations and standard errors in parentheses
† $p < .10$; * $p < .05$; ** $p < .01$; *** $p < .001$
5.1.3 Markets

Just as firms of different sizes and operating in different sectors face distinct threats and have access to distinct resources, the size and type of market in which a firm operates may also affect its property security strategies. A particularly significant dividing line is between firms whose operations are limited to a local market (e.g., a single region, city, or neighborhood) and firms servicing Russia’s national market. As suggested in Black’s (1976) classic work on societies’ reliance on law, the use of informal connections declines in favor of the use of impersonal legal institutions as the geographical distance between interacting parties expands. Personal connections, ties to criminal groups, and protection rackets that depend on local offices of government or law enforcement agencies have a greater impact within a confined environment. By contrast, firms operating with multiple offices throughout a large geographic expanse may find it inefficient and ineffective to continue relying on corruption and force to protect assets, given that they would have to invest in the development of informal connections in numerous locations.

In the survey I conducted, 53 percent of respondents report operating in a local market, with the remaining 47 percent operating throughout Russia’s national market. Not surprisingly, a disproportionate number of firms serving national markets are large. Only 20 percent of firms with less than 100 employees and 45 percent of firms with 101 to 250 employees operate nationally, whereas 68 percent of firms with over 251 employees have expanded beyond local markets. Table 5.3 compares the preferred property security strategies for firms operating in national markets with the strategies used by firms operating in local markets. As above, the preferred strategies refer to firms’ reported likeliness to use a given strategy to resolve an asset conflict, on a 1 to 7 scale where a rating of 1 means “highly unlikely” and 7 means “highly likely.”

For larger firms (those with more than 250 employees), there is evidence in support of the hypothesis that firms operating in an expanded market will rely less on strategies based on corrupt force. Large firms serving Russia’s national market are between 0.8 and 0.9 points (between 11 and 12 percent of the scale’s total range) less likely than large firms working in local markets to utilize informal connections in courts, or to turn to government officials and law enforcement agencies in a non-official capacity. The differences in means are statistically significant at conventional levels for all three strategies. On the other hand, the local-versus-national market distinction does not appear in the sub-sample of smaller firms. If anything, among smaller firms, those operating in national markets appear more likely to use strategies based on informal connections, although the differences in means are not statistically significant.4

4 OLS regression analyses with an interaction term for firm size and a dummy variable for type of market confirm the differential effect of market type on firms of different sizes, even controlling for the full range of confounding variables indicated in footnote 2.
### Table 5.3: Market Type and the Use of Corrupt Force to Resolve Property Conflicts

Average responses on a scale of 1 to 7, where 1 is “very unlikely” and 7 is “very likely”

<table>
<thead>
<tr>
<th></th>
<th>National Market</th>
<th>Local Market</th>
<th>T-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Firms with more than 250 employees</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Courts (with informal connections)</td>
<td>4.22</td>
<td>5.11</td>
<td>-2.05*</td>
</tr>
<tr>
<td>(with informal connections)</td>
<td>(82, 0.24)</td>
<td>(35, 0.36)</td>
<td></td>
</tr>
<tr>
<td>Bureaucrats (in private capacity)</td>
<td>3.62</td>
<td>4.45</td>
<td>-2.07*</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(87, 0.23)</td>
<td>(37, 0.33)</td>
<td></td>
</tr>
<tr>
<td>Law Enforcement (in private capacity)</td>
<td>3.68</td>
<td>4.51</td>
<td>-2.06*</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(86, 0.23)</td>
<td>(37, 0.33)</td>
<td></td>
</tr>
<tr>
<td><strong>Firms with less than 251 employees</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Courts (with informal connections)</td>
<td>4.63</td>
<td>4.01</td>
<td>1.61</td>
</tr>
<tr>
<td>(with informal connections)</td>
<td>(46, 0.31)</td>
<td>(105, 0.23)</td>
<td></td>
</tr>
<tr>
<td>Bureaucrats (in private capacity)</td>
<td>3.45</td>
<td>3.44</td>
<td>0.04</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(46, 0.32)</td>
<td>(111, 0.21)</td>
<td></td>
</tr>
<tr>
<td>Law Enforcement (in private capacity)</td>
<td>4.00</td>
<td>3.52</td>
<td>1.20</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(46, 0.34)</td>
<td>(111, 0.21)</td>
<td></td>
</tr>
</tbody>
</table>

Note: Mean values with number of observations and standard errors in parentheses

\( ^\dagger \ p < .10; \ ^* p < .05; \ ^{**} p < .01 \)
The fact that the effect of market type on property security strategies varies by firm size supports the notion, introduced above, that large firms have resources at their disposal to shift from force to law — once they have sufficient incentives to do so. Expansion into national markets requires that firms overcome new regulatory barriers, manage relationships with unfamiliar state officials, and devise solutions to complicated logistical problems. Larger firms that undertake such expansion (or firms that became large due to expansion) may be more capable than smaller firms of addressing these challenges through the use of legal resources.

5.2 Relational Assets

A second crucial factor that shapes firms’ property security strategies pertains to the types of people and organizations with whom a firm regularly interacts — its relational assets. Relational assets affect the resources at a firm’s disposal. Not just any firm has the resources to carry out strategies based on private or corrupt force. At some level, private protection services offered by government bureaucrats and law officials are sold on a market. But the illicit nature of these services means that their providers place a premium on personal connections, which help ensure that trust will not be betrayed or violations of the law reported.

As discussed above, larger firms are more likely to have greater access to informal connections. Their larger revenue allows them to devote more resources to cultivating ties to government officials; their larger ranks of managers and executives increase the probability that someone in the management suite has personal ties to regulatory agencies, law enforcement officials, or judicial institutions when a conflict arises. But firm size is not the only factor that affects access to connections. In some cases, managers of smaller firms may have childhood or university friends with ties to government and law enforcement agencies. For instance, the owner of an auto-service shop in Moscow explained why he has not had to rely on private security firms or formal law enforcement, because “By some quirk of fate, I have a lot of friends in the security and law enforcement agencies (silovye struktury). These are simply personal relationships, friends, acquaintances” (author interview, 10 December 2009, 121009-F42). Even for smaller firms, however, not all connections are a matter of chance. The clients, suppliers, and government officials with whom a firm regularly comes in contact during the course of its business are all relational assets that potentially shape firms’ property security strategies.

Consider, for example, the experience of a small business in Moscow that deals in high-end auto-parts and the outfitting of luxury cars. Nearly all clients are wealthy. Many are well-connected, such as a dissatisfied customer who turned out to be the son of a regional governor. In an environment where state resources can be applied for private use, this
created a unique type of challenge: The client threatened to use his father’s connections to increase inspections and cause problems with regulators unless the firm conceded to his demands (author interview, 10 February 2009, 021009-F1). Yet access to such clients is also an important resource, particularly for smaller firms that might otherwise not come into contact with wealthy, politically connected people.

In the survey I conducted, firms were asked to describe their primary customers or clients. One hundred twenty respondents, or just over 40 percent of the sample, reported a client base composed of individuals with significant wealth. In line with the hypotheses that wealthy clients are an important type of relational asset, Table 5.4(a) presents difference-of-means tests demonstrating that firms with wealthy clients report being more likely to utilize informal connections to resolve an asset dispute than firms without such clients. As in the preceding section, the preferred strategies refer to firms’ reported likeliness to use a given strategy to resolve an asset conflict, on a 1 to 7 scale where a rating of 1 means “highly unlikely” and 7 means “highly likely.” The effect is particularly pronounced for smaller firms, which appear to benefit disproportionately from the relational assets of a well-connected clientele. Whereas firms with wealthy clients in the full sample rate their likeliness to use bureaucrats or law enforcement officials in a private capacity approximately half a point higher on a 1 to 7 scale (approximately 7 percent of the scale’s full range), firms with fewer than 250 employees rate their likeliness to turn to bureaucratic or law enforcement protection rackets nearly a full point higher (approximately 14 percent of the scale’s full range).

Firms that have state-owned enterprises (SOEs) as either suppliers or customers may have an even more direct source of informal connections with government officials than firms with wealthy clients. Despite Russia’s massive privatization discussed in the preceding chapter, the state retains a significant ownership stake in approximately 10 percent of registered firms. The influence of these firms, however, is quite broad due to their size. Firms with a state ownership stake account for over one-third of all employment (Sprenger 2010, 6-7). Furthermore, they have extensive contact with fully private firms. Ninety-one firms in my sample, or nearly one-third, report that SOEs are significant customers or suppliers. Table 5.4(b) indicates that, as with wealthy clients, SOEs offer relational assets that make the use of property security strategies based on corrupt force more likely.

Firms do not only develop relational assets via clients and suppliers. Even interactions that can burden firms, such as inspections by regulatory agencies or extensive licensing procedures, may provide the opportunity for managers and owners to establish relationships with government officials. Once a firm establishes such connections, it may be more likely to turn to these informal channels rather than to formal institutions when conflicts arise. Thus, whereas previous research has suggested that a higher regulatory burden can drive firms into the informal sector (Johnson et al. 1997) or make them more likely to rely on criminal protection rackets for protection (Frye and Zhuravskaya 2000), the findings here indicate that firms’ utilization of illicit strategies does not necessarily induce flight from state
Table 5.4: Relational Assets and Property Security Strategies

Average responses on a scale of 1 to 7, where 1 is “very unlikely” and 7 is “very likely”

(a) Wealthy Clients and The Use of Corrupt Force to Resolve Property Conflicts

<table>
<thead>
<tr>
<th></th>
<th>Wealthy Clients</th>
<th>Non-Wealthy Clients</th>
<th>T-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All Firms</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Courts</td>
<td>4.51</td>
<td>4.16</td>
<td>1.23</td>
</tr>
<tr>
<td>(with informal connections)</td>
<td>(107, 0.22)</td>
<td>(150, 0.18)</td>
<td></td>
</tr>
<tr>
<td>Bureaucrats</td>
<td>3.88</td>
<td>3.40</td>
<td>1.76†</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(112, 0.21)</td>
<td>(156, 0.17)</td>
<td></td>
</tr>
<tr>
<td>Law Enforcement</td>
<td>4.16</td>
<td>3.51</td>
<td>2.35*</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(112, 0.23)</td>
<td>(156, 0.16)</td>
<td></td>
</tr>
</tbody>
</table>

(b) State-Owned Enterprises (SOEs) and Use of Corrupt Force to Resolve Property Conflicts

<table>
<thead>
<tr>
<th></th>
<th>SOE</th>
<th>No SOE</th>
<th>T-Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Customer/Supplier</td>
<td>Customer/Supplier</td>
<td></td>
</tr>
<tr>
<td>Courts</td>
<td>4.70</td>
<td>4.11</td>
<td>1.97†</td>
</tr>
<tr>
<td>(with informal connections)</td>
<td>(86, 0.24)</td>
<td>(171, 0.17)</td>
<td></td>
</tr>
<tr>
<td>Bureaucrats</td>
<td>3.97</td>
<td>3.42</td>
<td>1.87†</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(89, 0.24)</td>
<td>(179, 0.16)</td>
<td></td>
</tr>
<tr>
<td>Law Enforcement</td>
<td>4.06</td>
<td>3.64</td>
<td>1.42</td>
</tr>
<tr>
<td>(in private capacity)</td>
<td>(89, 0.24)</td>
<td>(179, 0.16)</td>
<td></td>
</tr>
</tbody>
</table>

Note: Mean values with number of observations and standard errors in parentheses
† $p < .10$; *$p < .05$; **$p < .01$
officials. Rather, firms that develop relational assets as they address regulatory burdens may actively seek to draw government officials acting in an unofficial capacity into disputes with other firms, thereby subverting formal institutions.

In the survey I conducted, firms were asked to rate on a 1 to 7 scale the extent to which acquiring licenses and permits is an obstacle to the success of their business, where 1 indicates “no obstacle” and 7 indicates a “major obstacle” (the average rating was 4.1). If the hypothesis that firms develop relational assets during regulatory procedures is accurate, then there should be a positive correlation between firms’ assessments of their regulatory burden and their reported likeliness of using property security strategies based on corrupt force to resolve an asset conflict. The regression analyses in Table 5.5 provide evidence of this correlation, even when taking into account confounding factors such as firm size (measured in the number of employees), the age and gender of respondents, foreign or government ownership stakes, participation in business associations, and firms’ city of location and sector. On average, for every additional point a firm perceives on the regulatory burden scale (labeled “licensing” in Table 5.5), it reports being between a fifth of a point (in the case of using courts with informal connections) to a quarter of a point (in the case of using law enforcement officials in an unofficial capacity) more likely to use property security strategies based on force. For all strategies involving corrupt force, the results are highly statistically significant. Similar results appear with respect to firms’ assessments of the extent to which inspections present an obstacle to the success of their business: There is a robust correlation between firms’ contact with inspectors and their reported likeliness of using corrupt force to resolve an asset dispute.

Further analysis, however, indicates that the relationship between regulatory burden and property security strategies is mediated again by firm size. If the variable for regulatory burden is interacted with the variable for firm size, the results are again highly statistically significant, as seen in Table 5.6. However, as indicated by the negative coefficient on the “licensing” variable, very small firms’ reported likeliness of using strategies based on corrupt force decreases as perceived regulatory burden increases. Meanwhile, as indicated by the positive and statistically significant coefficient on the “licensing*log(employee)” variable, the relationship between reported likeliness of using strategies based on corrupt force and perceived regulatory burden becomes increasingly positive as firm size increases.

For ease of interpretation, Figure 5.3 provides a graphical depiction of the relationship between regulatory burden, firm size, and firms’ reported likeliness to turn to government officials acting in an unofficial capacity — such as the bureaucratic rackets discussed in Chapter 2 — to resolve an asset dispute. The results are similar for other strategies based on corrupt force, such as reliance on informal connections in courts or rackets operated by law enforcement agencies. Regulatory burden is displayed on the horizontal axes, where 1

\[5\] OLS regressions are shown here. Ordered probit regressions produced similar results. All statistically significant results remain unchanged if robust standard errors are used.
Table 5.5: Regulatory Burden and Use of Force to Resolve Property Conflicts

OLS Regressions

<table>
<thead>
<tr>
<th></th>
<th>Courts (with connections)</th>
<th>Bureaucrats (private capacity)</th>
<th>Law Enforcement (private capacity)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept)</td>
<td>2.24 **</td>
<td>1.99 **</td>
<td>1.67 *</td>
</tr>
<tr>
<td></td>
<td>(0.82)</td>
<td>(0.76)</td>
<td>(0.77)</td>
</tr>
<tr>
<td>licensing</td>
<td>0.21 **</td>
<td>0.23 **</td>
<td>0.27 **</td>
</tr>
<tr>
<td></td>
<td>(0.08)</td>
<td>(0.07)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>log(employees)</td>
<td>0.17</td>
<td>0.13</td>
<td>0.13</td>
</tr>
<tr>
<td></td>
<td>(0.10)</td>
<td>(0.09)</td>
<td>(0.09)</td>
</tr>
<tr>
<td>age</td>
<td>-0.01</td>
<td>-0.10</td>
<td>-0.09</td>
</tr>
<tr>
<td></td>
<td>(0.07)</td>
<td>(0.07)</td>
<td>(0.07)</td>
</tr>
<tr>
<td>gender</td>
<td>-0.39</td>
<td>-0.29</td>
<td>-0.09</td>
</tr>
<tr>
<td></td>
<td>(0.30)</td>
<td>(0.27)</td>
<td>(0.28)</td>
</tr>
<tr>
<td>gov_own</td>
<td>-0.03</td>
<td>0.08</td>
<td>-0.39</td>
</tr>
<tr>
<td></td>
<td>(0.58)</td>
<td>(0.54)</td>
<td>(0.54)</td>
</tr>
<tr>
<td>foreign_own</td>
<td>0.88 †</td>
<td>0.21</td>
<td>0.48</td>
</tr>
<tr>
<td></td>
<td>(0.51)</td>
<td>(0.46)</td>
<td>(0.47)</td>
</tr>
<tr>
<td>bus_assoc</td>
<td>0.33</td>
<td>0.25</td>
<td>0.34</td>
</tr>
<tr>
<td></td>
<td>(0.32)</td>
<td>(0.29)</td>
<td>(0.29)</td>
</tr>
<tr>
<td>city dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>sector dummies</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td>N</td>
<td>250</td>
<td>262</td>
<td>261</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.09</td>
<td>0.14</td>
<td>0.13</td>
</tr>
<tr>
<td>adj. $R^2$</td>
<td>0.05</td>
<td>0.10</td>
<td>0.09</td>
</tr>
<tr>
<td>Resid. sd</td>
<td>2.19</td>
<td>2.06</td>
<td>2.08</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
† significant at $p < .10$; *$p < .05$; **$p < .01$; ***$p < .001$

indicates that the firm perceives licensing and permit regulation to be “no obstacle” to the success of its business and 7 indicates a that regulation is a “major obstacle.” Likelihood to use bureaucratic rackets to resolve an asset dispute is displayed on the vertical access, where 1 indicates the firm is “highly unlikely” to use the given strategy and 7 indicates “highly
likely.” Firms in the sample were divided in micro (less than 15 employees), small (between 16 and 100), medium (between 101 and 250), and large or very large (greater than 250). The black lines indicate predicted values on the 1 to 7 scale of reported likeliness to use bureaucratic rackets, given firm size and perceived regulatory burden, based on a model similar to that specified in Table 5.6. The negative correlation between perceived regulatory burden and likeliness to turn to bureaucratic rackets is readily apparent for micro firms; there is almost no relationship for small firms; and for larger firms the correlation is visibly positive.

Table 5.6: Regulatory Burden, Use of Force, and the Mediating Effects of Firms Size

OLS Regressions (control variables suppressed)

<table>
<thead>
<tr>
<th></th>
<th>Courts (with connections)</th>
<th>Bureaucrats (private capacity)</th>
<th>Law Enforcement (private capacity)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Intercept)</td>
<td>4.11***</td>
<td>4.92***</td>
<td>4.30***</td>
</tr>
<tr>
<td></td>
<td>(1.20)</td>
<td>(1.08)</td>
<td>(1.09)</td>
</tr>
<tr>
<td>licensing</td>
<td>-0.24</td>
<td>-0.47 *</td>
<td>-0.36 †</td>
</tr>
<tr>
<td></td>
<td>(0.22)</td>
<td>(0.20)</td>
<td>(0.20)</td>
</tr>
<tr>
<td>log(employees)</td>
<td>-0.20</td>
<td>-0.45 *</td>
<td>-0.40 *</td>
</tr>
<tr>
<td></td>
<td>(0.20)</td>
<td>(0.18)</td>
<td>(0.18)</td>
</tr>
<tr>
<td>licensing*log(employees)</td>
<td>0.09 *</td>
<td>0.15 ***</td>
<td>0.13 **</td>
</tr>
<tr>
<td></td>
<td>(0.04)</td>
<td>(0.04)</td>
<td>(0.04)</td>
</tr>
<tr>
<td>N</td>
<td>250</td>
<td>262</td>
<td>261</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.11</td>
<td>0.18</td>
<td>0.17</td>
</tr>
<tr>
<td>adj. $R^2$</td>
<td>0.07</td>
<td>0.14</td>
<td>0.13</td>
</tr>
<tr>
<td>Resid. sd</td>
<td>2.18</td>
<td>2.00</td>
<td>2.04</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
† significant at $p < .10$; *$p < .05$; **$p < .01$; ***$p < .001$

These results again indicate that the presence or absence of relational assets affects firms of different sizes in distinct ways. When very small firms regularly are confronted with regulation and inspections, the relationship appears to asymmetrically favor state officials. A regulatory burden is imposed, but firms do not have the capacity to develop relational assets. By contrast, among larger firms, while they may chafe under the regulation, the regular interaction with government officials is an opportunity to develop personal connections, which can then be relied on during conflicts such as asset disputes.
CHAPTER 5. WHO USES LAW?

Figure 5.3: Regulatory Burden and Bureaucratic Rackets, by Firm Size

Horizontal axis: Licensing as an obstacle to doing business, where 1 is “no obstacle” and 7 is “major obstacle.” Vertical axis: Likeliness to use bureaucrats in private capacity to resolve asset dispute, where 1 is “highly unlikely” and 7 is “highly likely.” The black lines represent predicted values based on a model specification similar to that presented in Table 5.6. The dotted lines represent 95 percent confidence intervals.

In summary, relational assets are intertwined with firms’ property security strategies. The type of clients, suppliers, and government officials with whom a firm frequently interacts shapes the resources at its disposal. These resources in turn influence the types of strategies firms use to protect their assets.

5.3 Legal Foundations and Choke Points

Another fundamental source of variation pertains to “choke points” in the life cycle or supply chain of a firm. These choke points are foundational moments that affect a firm’s property security strategies far into the future. Two key examples include licensing burdens that prevent firms from building a solid legal foundation for their business and customs regulations that prevent firms from legally conducting imports. These types of choke points force firms to avoid the use of property security strategies based on formal institutions for fear of exposing their own legal violations. Consequently, law becomes a less valuable resource for protecting assets.

Until the early 2000s, it was nearly impossible to build a fully legal foundation for a business.
According to a longtime owner of several small businesses in Moscow, one significant source of the problem was the difficulty in leasing office space on an official basis, in part because landlords sought to avoid taxation. Yet many other official documents and licenses were unobtainable without documentation of a valid lease, forcing firms to seek further loopholes in laws and regulations in order to continue the process of starting up a business. Therefore, from the early stage of locating premises for a new business, many firms were forced to operate in semi-legality (author interview, 25 May 2009, 052509-F23). As discussed in the previous chapter with respect to incomplete tax compliance, firms operating with legal violations are hesitant to turn to formal legal institutions in times of need for fear that their own violations will be revealed in the process.

In addition to the foundational moments of building a business, choke points can also occur at significant points along a firm’s supply chain. The most pressing example in the Russian context involves imports. Due to corruption, long delays, and a general desire to avoid duties, schemes to bypass customs inspections were rampant in the 1990s and remain a dire problem to this day. An OECD analysis of Russia’s trade with its 15 largest trading partners between 1996 and 2001 revealed an enormous discrepancy between the value of exports to Russia recorded by trading partners — approximately 175 billion dollars — and the value of imports recorded by Russian statistics during this period — 124 billion dollars. Estimates suggest that only 20 percent of imported goods during the period in question were fully and properly declared; 70 percent were brought in using “grey” tactics, such as misreporting the product category, price, or quantity; and 10 percent were smuggled in outright (OECD 2005, 33-34; Radaev 2002, 17). The illegal or semi-legal import of goods has ramifications for downstream business. Without proper documentation, wholesalers, retailers, and traders are subject to investigation and prosecution; they thus have an incentive to avoid formal institutions.

Licensing and registration reforms begun in the early 2000s have to some extent alleviated the barriers to building a sound legal foundation for a new business. Similarly, customs reforms enacted in 2004 have to some degree increased the feasibility of conducting legal imports. Yet to the extent that these reforms have affected firms unevenly, we would expect choke points to affect some firms’ property security strategies more than others. As one example, Radaev’s (2000, 29-30) in-depth study of import schemes demonstrates that the price structure of goods contributes to the extent to which they can be legally imported. A complex series of informal rules drives de facto customs duties toward an average value. Consequently, goods of average value enter the country with full legality; importers of cheaper goods end up paying extra; and importers of expensive goods end up paying less.

Russian businesspeople specifically refer to choke points during in-depth interviews. For example, a procurement manager of a major Russian cellular phone retailer attributed the relative disappearance of illegal business practices in his sector to its legal imports, purchased from large international sellers such as Nokia and Motorola (author interview, 24 November
2009, 112409-F35). Unfortunately, comprehensive analysis of the relationships between choke points and property security strategies requires access to data that does not currently exist. As a proxy for legal foundation, I considered data from the survey I conducted regarding firms’ ranking of access to office space as a barrier to the success of their business. However, such a variable captures not only the difficulties associated with leasing an office in a legal fashion, but also problems pertaining to the dearth of office space in Russia, making it a highly imperfect measure of the issue at hand. Consequently, I was not able to establish robust correlations between these rankings and firms’ preferred property security strategies.

Similarly, I sought to examine the relationship between imports, distinct types of products, and property security strategies. Broad comparisons of output — physical products versus services — as discussed earlier in this chapter are not fine-grained enough to produce robust results. On the other hand, dividing the sample into specific industries revealed some preliminary findings. For example, importers in the construction industry, retailers, and wholesalers are more likely than non-importers in these sectors to use strategies based on force. The opposite appears true among manufacturing firms. Nevertheless, without more detailed data on the value of specific types of goods and their customs tariffs, it is difficult to establish whether these distinctions are related to choke points or to some other factor.

In summary, according to in-depth interviews with Russian firms, choke points that undermine the legal foundation of a firm or affect downstream business practices can have an effect on the resources at a firm’s disposal. When firms are unable to operate legally, property security strategies based on law become less accessible. Further collection of data will facilitate additional examination of this source of variation in firms’ property security strategies.

5.4 Conclusion

The sizeable shift in Russian firms’ property security strategies from force to law, discussed in Chapter 4, has affected firms unevenly. To understand variation in property security strategies across firms, it is essential to consider the threats firms face and the resources at their disposal. These shape the incentive structures that underlie strategies for protecting assets. Threats and resources vary by firm size, sector, and the characteristics of the market in which a firm operates. Additionally, the relational assets a firm develops through its clients, suppliers, and interaction with government officials shape the threats it faces and its access to resources. Finally, the extent to which firms are able to overcome choke points that can force them to avoid contact with formal legal institutions, the more likely they will be to perceive law as a valuable and accessible resource.

Variation in property security strategies across different types of firms is of great importance
for the politics of institutional development. Identifying which private sector actors face
greater incentives to rely on law is a significant prerequisite for determining what types of
pro-reform constituencies might emerge to support institutional development. Such questions
about the broader economic and political effects of property security strategies are addressed
in the concluding chapter.
Chapter 6

From Demand for Law to the Rule of Law

To return to the issue with which this study began, there is a near consensus regarding the importance of institutions — particularly institutions that protect property rights — for economic growth and societal being. Yet despite the vast literature on their positive effects, scholars are only beginning to understand the origins of the institutions that provide for secure and stable property rights.

Existing scholarship has approached the study of institutional origins from the perspective of rulers. Such studies examine rulers’ incentives to expropriate assets or support the development of institutions that protect property rights, usually with the aim of increasing economic growth so as to collect higher tax revenues. All else equal, the existing literature has concluded that rulers are less likely to engage in expropriation and more likely to engage in institutional building when: (1) rulers expect to remain in power for extended periods of time (e.g., Olson 1993); (2) rulers have access to relatively efficient technology for monitoring and enforcing tax compliance (North 1981, 1990); (3) rulers do not fear that economic growth will unsettle their grip on political power (Acemoglu and Robinson 2006); and (4) rulers face a well-organized and politically powerful set of constituents who make compromise relatively more advantageous than repression (Levi 1989; North 1981).

Focused primarily on the history of the West, these studies assume the convergence between formal rules and de facto practices. Yet throughout the developing and post-communist world, such convergence is not the norm. Whereas existing studies assume that a supply of institutions will automatically create demand, Chapter 2 of this study emphasized that it is by no means clear that once formal rules are in place, compliance will immediately follow. It is even less of a given that constituents will come to recognize formal institutions as resources that can be used to advance citizens’ interests.
In contrast to the literature on property rights, scholars of post-communist politics have recognized the importance of the “demand-side” of institutional development, or what has often been called “demand for law” (Hendley 1997, 1999). However, analysts in the post-communist context have become mired in debates over whether Russia’s emerging business class seeks to promote or undermine institution building. This perspective that private sector actors are either supporters or opponents of institutional development is misleading. Firms’ strategies for protecting assets have changed over time, as discussed in Chapters 2 and 4. Moreover, different types of firms develop distinct property security strategies, as discussed in Chapter 5. Thus, the pressing issue is to identify the factors that contribute to variation in firms’ behavior both over time and across different types of enterprises.

Ultimately, the goal should be to develop a theory of institutional demand that can be paired with existing theories about institutional supply, leading to a truly comprehensive theory of institutional formation. This study has offered the preliminary foundations for such a demand-side theory.

6.1 Toward a Comprehensive Theory of Property Rights Formation

I have argued that firms’ shift in property security strategies has occurred not because of a normative shift and not primarily because of the state’s increased enforcement capacity. Rather, changes in firms’ incentive structure have made it less advantageous to use force and more advantageous to use law. However, the focus on incentives in societies in which institutions themselves are in flux creates a conundrum. Institutions are usually considered to shape incentives structures, so what accounts for actors’ incentives when institutions are in formative stages?

This study has offered four sets of answers regarding the sources of incentive transformations during periods of institutional flux: First, incentive shifts can result from changes within the structure of firms themselves. The examples analyzed in detail in this study pertained to the consolidation of ownership in privatized firms and the modernization of the places where people work and shop. By creating incentives for longer term investment, providing protection from physical threats, and placing new types of resources for legal protection at firms’ disposal, these changes in ownership structure contributed to the transformation of firms’ property security strategies, facilitating a shift from force toward law.

Second, incentive shifts can result from evolution in other institutional spheres. For example, in this study I focused on the effects of tax administration and banking sector development on property security strategies and, ultimately, on the formation of legal institutions. While these types of incentive shifts may result from the efforts of rulers or state officials, as in
the case of tax reform, they differ fundamentally from changes in firms’ behavior that result from the state’s increased enforcement capacity. Indeed, state officials in many cases might not even envision that their reforms in a separate institutional sphere would have an effect on property security strategies. In other instances, the primary impetus for change might be unrelated to the state. The development of the banking sector, for example, resulted largely from private sector actors’ quest for profit in a rapidly growing market for financial services.

Third, incentive shifts can result from external pressures, as in the case of foreign investment. As firms increasingly rely on international financing, they hesitate to use illegal property security strategies that could harm their reputation, reduce their value, and frighten away prospective investors.

Fourth, as discussed in Chapter 3, once an incentive transformation induced by external factors takes place, self-sustaining dynamics may emerge. Firms’ use of the law raises the benefits for other firms using the law, just as firms’ use of force necessitates more use of force by other firms. This coordination effect is a powerful and independent factor with the potential to alter firms’ strategies for protecting assets.

It is worth noting that many of the factors contributing to firms’ incentive transformation — ownership structure changes, banking sector development, international investment — would have been highly unlikely to occur without economic growth. In this sense, it appears that economic growth may be a necessary, although not sufficient, condition for the transformation from force to law. Clearly, many countries have experienced growth spurts without accompanying changes in firms’ behavior or in larger scale institutional development. Growth may be a prerequisite for the transformation of property security strategies, but alone it cannot ensure that processes such as ownership structure evolution, banking sector development, or international investment will occur to a sufficient extent to induce changes in firms’ behavior.

In addition to examination of changes in firms’ property security strategies over time, analysis of variation in strategies across different types of firms offers further insights into the factors that affect firm behavior. In particular, the threats firms face and the resources at their disposal shape the incentive structures underlying firms’ property security strategies. All else equal, medium-sized firms are more likely to utilize strategies based on law. Smaller firms suffer disproportionately in an environment in which force is widespread, but they do not necessarily have the resources to adapt their strategies. Larger firms have the resources needed to adapt their behavior, but they may possess comparative advantages in an environment where force is extensive and therefore hesitate to rely on law. Meanwhile, firms producing or distributing physical products, as opposed to providing services, face more concrete threats to their assets and therefore place more value on the transformation from force to law. Finally, firms that develop relational assets — customers, suppliers, government officials with whom they regular interact — who can offer connections needed for the use of private or corrupt force naturally have a greater incentive to use such resources to resolve
conflicts.

These findings support the notion that an incentive transformation underlies the shift in Russian firms’ property security strategies. Yet given that many of these incentive transformations happened during the same period in which Putin rose to power and the Russian state regained its enforcement capacity, how can we distinguish between the effects of incentive shifts and the rise in the state’s coercive power? In part, as discussed in Chapter 1, coercion alone is an expensive and ineffective tool to induce compliance. Widespread compliance almost always requires some form of voluntary compulsion, either due to normative convictions or to the belief that compliance is self-serving, and thus overreliance on coercion as an explanatory factor is bound to offer an incomplete explanation. Second, firms, lawyers, and private security agencies themselves attribute their actions less to changes in state enforcement capacity than to the factors discussed in Chapters 3, 4, and 5. While actors can mislead, either intentionally or inadvertently, each inductively derived hypotheses was vetted through a series of additional analytical steps. I first confirmed that a major shift in the explanatory variable had indeed occurred. I then examined whether reasonable causal mechanisms linking the explanatory variable and property security strategies existed. And, finally, I used survey data to test for a correlation between the explanatory variables and firms’ property security strategies. The fact that three approaches — in-depth qualitative interviews, theoretical analysis, and quantitative analysis of survey data — point to the same conclusions is reassuring and indicates that a transformation in incentive structures, not merely the state’s increased enforcement capacity, has driven the shift in Russian firms’ property security strategies.

6.2 The Importance of Property Security Strategies

6.2.1 The Capacity of State Institutions

This study has focused on property security strategies. To some extent, such strategies are important in and of themselves. For example, the use of private violence or corruption to protect assets clearly has detrimental societal effects. But ultimately, the aim of this study is to better understand the origins of institutions that protect property. The claim issued above was that it is insufficient to consider the actions of rulers. Consideration of firms’ use, subversion, or circumvention of formal institutions is also necessary to understand the origins of effective institutions.

To what extent is there evidence that firm behavior affects the performance of state institutions? First, recall the definitions of distinct property security strategies introduced in Chapter 1: (1) Private force relies on private actors with the capacity to wield violence to
protect property claims. (2) Corrupt force relies on state actors who wield violence without regard to the distinction between legal and illegal coercion. (3) Delegated law relies on private actors who use non-violent means to enforce property rights. And (4) strategies of institutionalized law rely on state actors who resort to violence and coercion only in accordance with formal rules.

Figure 6.1: Effects of Property Security Strategies on State Institutions

On one level, the question of property security strategies’ effects on institutions is straightforward almost to the point of being tautological. Figure 6.1 reproduces the typology introduced in Figure 1.1 of Chapter 1. Each cell presents the hypothesized effects of each type of strategy on state institutions. Private force directly challenges the state’s monopoly on coercion, destabilizing and undermining state institutions. Corrupt force directly subverts state institutions by abusing the authority of the state. On the other hand, delegated law works in complementary fashion with formal state institutions. Private arbitration, for example, may reduce the caseload burden on the state court system, but the backing of the state’s coercive power is what makes private arbitration effective. Finally, institutionalized law reinforces state institutions. If firms circumvent formal institutions, then they make the state’s institutions irrelevant for real-world business practices. When they rely on state institutions to advance their interests, firms contribute to the merging of formal rules and de facto practices.

Ideally, however, we would like to be able link firms’ strategies to some measure of institutional performance or durability. This presents significant challenges, because changes in
in institutional performance affect firms’ strategies, just as strategies affect institutional performance. Consider, for instance, what happens when firms increase their use of property security strategies based on law. With fewer legal violations, the burden on law enforcement officials and courts becomes more manageable, potentially allowing them to function more effectively. The improved enforcement capacity of the state then creates further incentives for firms to shift from strategies based on force to strategies based on law. Analytically, the cyclical, reinforcing relationship between property security strategies and institutional performance is of little concern. Empirically, it means that establishing a rigorous causal effect of firms’ strategies on institutional performance is quite difficult.

Nevertheless, given the stage in which the research agenda on institutional origins finds itself, my intention in this study was to ask the bigger questions, sometimes at the expense of causal identification. Previous work on property rights does not comprehensively consider the role of demand-side factors. This study draws attention to their importance and offers hypotheses and evidence about the factors that affect firms’ behavior, as well as differences across firms. Future research will be needed to further address the effect of strategies on institutional performance.

### 6.2.2 Lobbying for Law

A second way in which property security strategies may matter is their connection to private sector actors’ lobbying activity. In addition to firms’ use of formal institutions, another dimension of demand for law includes how firms lobby for institutional reforms. Scholars have explored this lobbying aspect of demand for law with respect to Russian tax reform (Jones Luong and Weinthal 2004), reform of bankruptcy legislation (Woodruff 2004), and the oligarchs’ role in reforms ranging from legislation on capital accounts, land ownership, and the judicial system (Guriev and Rachinsky 2005). These studies have contributed to the debates, discussed in Chapter 1, over whether Russia’s emerging business class constitutes a lobby for the rule of law. Lost in these debates has been the distinct incentives faced by different types of private sector actors. As examined in Chapter 5, firms of different sizes, from different sectors, operating in different markets, and possessing different types of relational assets face distinct tradeoffs between the benefits and constraints resulting from a widespread shift from force to law. Presumably, these distinct incentive structures affect firms’ willingness to lobby for institutional reform, although firms’ capacity for collective action combines with these preferences for or against institutional change to determine actual lobbying outcomes. In other words, variation in property security strategies across different types of firms potentially can offer clues to pro-reform constituencies that could be mobilized by political entrepreneurs, but future research will be needed to assess the relationships between on-the-ground business practices and firms’ support or opposition to reforms at the level of formal institutions.
SECTION 6. FROM DEMAND FOR LAW TO THE RULE OF LAW

6.3 Geographical Variation

This study has focused on evolution of property security strategies over time and variation across different types of firms. Russia is a large country, however, and there is extensive regional variation in political and economic trends, as aptly demonstrated in recent studies such as Brown et al. (2009) and Yakovlev and Zhuravskaya (2007). Naturally, the trends discussed in this study have not occurred evenly across Russia’s regions. In particular, skeptics may question whether the shift from force to law is something that has primarily affected Moscow and St. Petersburg. The interviews I conducted in the Siberian town of Barnaul were specifically carried out to address this issue. As discussed in Chapter 2, these interviews indicated that the transformation of property security strategies was not by any means limited to Russia’s two major metropolises. As a Barnaul lawyer concluded, “...people more or less have come to resolve disputes in a civilized way, by going to court.” He further noted that courts are so packed with litigants that “...to move through the corridors of a courthouse is now impossible” (author interview, 30 September 2009, 093009-L22).

The inclusion of regional cities in the survey I conducted was intended to further address the issue of regional variation. In addition to Moscow and St. Petersburg, the survey included 125 firms from Nizhniy Novgorod, Samara, Kazan, Rostov-on-Don, Ekaterinburg, and Novosibirsk. Reconsidering the indicators of a shift from force to law discussed in Chapter 2 offers evidence that significant changes have occurred in Russia’s regions. For example, when respondents were asked how often they or their employees personally encountered threats of or actually use of violence during the course of doing business, only four percent of the overall sample reported that such violence occurs “sometimes” or “frequently.” Seventy-six percent responded that they never experience such violence. As seen in Table 6.1(a), firms in Moscow were actually more likely to report encounters with violence than firms in the regions. Similarly, respondents were asked whether they had been in contact with criminal protection rackets, both at any point during their firm’s existence and during the last three years. Eighteen percent of the overall sample reported contact at some point in the past, while only four percent reported recent contact. Again, the regional averages were lower than the averages for Moscow, although higher than for St. Petersburg, as shown in Table 6.1(b).

Finally, as shown in Table 2.4 in Chapter 2, when respondents were asked to rank how likely they would be to utilize various strategies to resolve an asset dispute, strategies based on institutionalized law (e.g., having lawyers settle the dispute out of court, using the commercial courts, turning to government bureaucrats or law enforcement agencies in their official capacity) were ranked the highest. These were followed by strategies based on corrupt force

1 Hendley (1998) and Hendley et al. (1998) similarly reported that regional distinctions in firms’ use of the courts were less stark than expected, even in the 1990s.
(e.g., using the courts along with informal connections, turning to government bureaucrats or law enforcement agencies in an unofficial capacity) and strategies of delegated law (e.g., help from business associations or the use of private arbitration). Finally, strategies of private force (e.g., criminal protection rackets or private security agencies) were rated lowest. Table 6.2 shows the ratings with the sample divided into Moscow firms, St. Petersburg firms, and regional firms. The order of rankings of preferred strategies apparent in the overall sample is consistent across all three subgroups.

In summary, the evidence suggests that the transformation in property security strategies from force to law is a broad trend. This is not to deny variation in business practices across Russia’s vast federation. But despite this variation, the majority of firms throughout Russia have come to rely extensively on institutionalized law, while the violent practices of the 1990s have receded into the past.
### Table 6.1: The Use of Force by Region

(a) Frequency of Encounters With Violence of Threats of Violence While Doing Business

<table>
<thead>
<tr>
<th>Region</th>
<th>Never</th>
<th>Rarely</th>
<th>Sometimes</th>
<th>Frequently</th>
<th>Very Frequently</th>
<th>Don’t Know</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full sample</td>
<td>72</td>
<td>20</td>
<td>3</td>
<td>1</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>Moscow</td>
<td>62</td>
<td>24</td>
<td>5</td>
<td>2</td>
<td>0</td>
<td>7</td>
</tr>
<tr>
<td>St. Petersburg</td>
<td>83</td>
<td>17</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Regions</td>
<td>75</td>
<td>18</td>
<td>4</td>
<td>0</td>
<td>0</td>
<td>3</td>
</tr>
</tbody>
</table>

(b) Contact with Criminal Protection Rackets

<table>
<thead>
<tr>
<th>Region</th>
<th>Ever</th>
<th>Last 3 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full sample</td>
<td>18</td>
<td>4</td>
</tr>
<tr>
<td>Moscow</td>
<td>23</td>
<td>6</td>
</tr>
<tr>
<td>St. Petersburg</td>
<td>12</td>
<td>0</td>
</tr>
<tr>
<td>Regions</td>
<td>18</td>
<td>5</td>
</tr>
</tbody>
</table>
### Table 6.2: Firms’ Preferred Property Security Strategies, by Region

Average responses on a scale of 1 to 7, where 1 is “very unlikely” and 7 is “very likely”

<table>
<thead>
<tr>
<th>Institutionized Law</th>
<th>Moscow (avg.)</th>
<th>St. Petersburg (avg.)</th>
<th>Regions (avg.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rely on lawyers to resolve the dispute out of court</td>
<td>5.70</td>
<td>6.39</td>
<td>6.10</td>
</tr>
<tr>
<td>Turn to the commercial courts</td>
<td>5.50</td>
<td>5.67</td>
<td>5.86</td>
</tr>
<tr>
<td>Seek the help of law enforcement officials in formal capacity</td>
<td>4.74</td>
<td>5.31</td>
<td>5.45</td>
</tr>
<tr>
<td>Seek the help of government bureaucrats in formal capacity</td>
<td>4.45</td>
<td>4.83</td>
<td>4.50</td>
</tr>
</tbody>
</table>

| Corrupt Force | | | |
| Turn to the commercial courts, using informal connections | 4.02 | 4.89 | 4.21 |
| Seek the help of law enforcement officials in an informal capacity | 3.55 | 4.44 | 3.56 |
| Seek the help of government bureaucrats in an informal capacity | 3.54 | 4.31 | 3.28 |

| Delegated Law | | | |
| Settle the dispute in a private arbitration forum | 3.21 | 4.08 | 2.74 |
| Seek the help of a business association | 3.02 | 2.69 | 2.63 |

| Private Force | | | |
| Seek the help of a private security agency | 1.88 | 2.36 | 2.38 |
| Seek the help of criminal or mafia groups | 1.64 | 2.08 | 1.92 |

Respondents were asked the following question: *Let’s say that a competitor is trying to gain control of some significant physical asset owned by your firm (e.g., office space or a factory). To defend its assets, how likely would a firm like yours be to do each of the following?*
6.4 Transitions to the Rule of Law Outside of the West

Scholars’ dearth of understanding when it comes to institutional origins is not limited to institutions that protect property rights. It pertains more broadly to the foundations of the rule of law, which remain strikingly understudied compared to other prominent topics in political science such as the foundations of democracy. In a recent article, Francis Fukuyama (2010, 33) pointedly notes that:

Liberal democracy is held to be a combination of two sets of institutions — democratic ones that ensure that governments are accountable to popular choice, and liberal ones that provide for rule of law. There is a huge literature on democratic transitions, much of it written since the onset of Samuel P. Huntington’s “third wave” of democratization in the mid-1970s... It is a bit strange, however, that relatively little analytical work has been done on transitions to the rule of law that is comparable to what has been done on transitions to democracy.

As a baseline for future comparative research, Fukuyama offers an analysis of the origins of the rule of law in the West. He attributes the formation of institutionalized law — codified in writing, interpreted by legal specialists, and with institutional autonomy from other sources of political authority — to a unique history. Much in the vein of Harold Berman’s (1983) classic work on the foundations of law, Fukuyama suggests that this unique history is rooted in transcendental religions, such as Christianity, Islam, and Hinduism, in which even rulers were accountable to divine laws. However, only in Europe did the Reformation and Enlightenment foster the transformation of a society bound by religious rules to a society bound by secular rules. Elsewhere, colonialism destroyed the organic, religious foundations of the rule of law.

Whether or not one accepts Fukuyama’s account in full, it points to the fundamental limitations of the application of the Western experience to the building of the rule of law in developing and post-communist countries. History cannot be relived, and culturally embedded religious traditions cannot be undone. What is needed are theories that move beyond religion, culture, and history to provide insights into the sources of the rule of law.

As discussed in Chapter 1, demand for law is just one aspect of the rule of law, which is a much broader concept that encompasses constraints both on private and state actors, and which pertains not just to property rights and the economic sphere but also to “a body of rules of justice that binds a community together” (Fukuyama 2010, 34). Yet the study of demand for law offers some broader guidelines that suggest a preliminary foundation for a theory of transitions to the rule of law in non-Western countries. First, incentive transformations can precede transformations in norms and beliefs. Centuries of history cannot be rewritten, but the dramatic shift in Russian firms’ property security strategies indicates that changing incentive structures can lead to rapid changes in actors’ willingness to contribute to a rule-
bound society. Second, for much of the developing world, the critical struggle is not about creating the rule of law but enforcing the rule of law. Throughout the world, governments are accepting the formal trappings of law, but they often lack the will or capacity to give formal institutions teeth. Meanwhile, societal actors often face inadequate incentives to change their behavior, leading to a sharp divergence between de facto practices and formal rules.

Third, unlike the history of the West, transitions to the rule of law in the developing world are taking place in the context of a globalized world. International actors play an essential role in shifting incentives. In addition to direct influence, such as the foreign investors discussed in this study, the mere existence of a template of rule-based capitalism and liberal democracy in the West has a powerful influence. In Russia, for example, businesspeople regularly compare their form of capitalism to “civilized” Western capitalism, and consequently they calibrate their actions to account for the possibility that practices that are acceptable today will result in sanctions in the near future. Thus, unlike the organic, unintentional development of the rule of law in the West, in the developing and post-communist worlds, the actors themselves are situated in historical context such that the formation of the rule of law is a conscious process. Fourth, the rule of law is broader than developments in the economic sphere, but nonetheless the business sector may play a critical role in its development. The business sector remains the sphere of society with the most direct material incentives, and the most access to resources, to provide a demand for law. This is particularly true in authoritarian countries such as Russia, where few organizations outside of the private commercial sector possess relative autonomy from the state.

These guidelines, particularly the fact that pathways to the rule of law involve an incentive transformation, suggest several conclusions with relevance for policy prescriptions. First, in searching for ways to transform incentives, rule of law efforts should focus beyond the judicial system itself. Changes in other institutional spheres — such as tax administration or banking sector development, as explored in this study — can have equal or even greater influence on actors’ incentives to rely on law. Second, since incentives depend on other actors’ use of law, the provision of information can have powerful effects. Information campaigns emphasizing other actors’ increased use of law and formal institutions, which were actively used by Russian authorities to support tax reforms in the early 2000s, may induce additional reliance on law. Finally, the focus on incentives suggested here indicate that development efforts, such as those inspired by the influential work of Hernando de Soto (2000), to bring actors out of the informal sector through the formalization of their title to property may be misleading in their emphasis on formal institutions at the expense of incentive transformations. This is especially true in the post-communist world where the most fundamental property rights for economic growth pertain to ownership stakes in privatized and newly-created firms. Unlike property rights involving housing or farmland, the property rights underlying productive assets in a modern market economy are incredibly complex, increasing the likeliness that a divergence between formal ownership and de facto control will occur.
6.5 Toward the Rule of Law in Russia?

Demand for law may be just one component of the rule of law, but it is a crucially important one. Russia provides vivid illustration of this point. The threats of the 1990s — physical violence, outright criminality, unscrupulous competitors and business partners — have largely faded into the past. But they have been replaced by new threats — highly sophisticated fraud, harassment from state bureaucrats and law enforcement officials, and direct attempts by top government officials to expropriate property rights.

Figure 6.2 reproduces Figure 1.2 from Chapter 1 and depicts the relationship between private threats, state threats, and the rule of law. The chaotic conditions of the early-to-mid 1990s discussed in Chapter 2, where property security strategies regularly depended on criminal protection rackets, private security agencies, and corrupt public officials, is best described as the *rule of chaos*. In such situations, the threat from both state and private actors is high. As powerful business tycoons increased their control of state institutions, Russia entered a phase best characterized as a *weak state*, where private actors, rather than state actors, posed the primary threat to property rights.

As Putin consolidated power in the early 2000s, he tamed the influence of private oligarchs and prioritized the strengthening of state institutions. Meanwhile, as discussed throughout
CHAPTER 6. FROM DEMAND FOR LAW TO THE RULE OF LAW

this study, firms increasingly came to rely on property security strategies based on law. This reprieve from both private and state threats came close to the creation of the rule of law, at least in the sphere of the economy. Such reprieve was short-lived. Particularly after the state’s attack on the oligarch Mikhail Khodorkovsky in 2003, bureaucrats and law enforcement officials of all ranks increased their pressure on firms. Diminished private threats combined with grave threats from a predatory state is increasingly the situation Russia finds itself in today.

Three primary threats emanate from the Russian predatory state: (1) attacks by high-level state officials, including close associates of Putin; (2) harassment by lower-level bureaucrats via abuse of regulatory statutes; and (3) pressure from law enforcement officials via abuse of the Criminal Code.

6.5.1 Attacks by High-Level Officials

The most high-profile attack by Russian officials was the arrest of Khodorkovsky for tax evasion and fraud in 2003, an attack orchestrated by members of Putin’s inner circle. Khodorkovsky, having amassed a fortune through his exploits in the banking and oil sectors, was at the time Russia’s wealthiest man. The charges ultimately led to the bankruptcy of Khodorkovsky’s oil company, Yukos, whose most lucrative assets ended up in the possession of the state-owned Rosneft oil company after a series of non-transparent auctions.

The Khodorkovsky Affair, however, is not an isolated incident, particularly in the energy sector. Rather than continuing to play a dangerous game, the oligarch Roman Abramovich voluntarily sold his oil company Sibneft to state-owned Gazprom in 2005 (Kramer 2005). Others were not so fortunate. In 2006 Gazprom acquired a majority stake in the Sakhalin-2 oil and gas project after Royal Dutch Shell, facing legal proceedings for ostensible violations of environmental regulations, agreed to sell some of its assets (Kramer 2006). In 2007 Mikhail Gutseriyev, having fallen out of favor with Kremlin-backed leadership in the Republic of Ingushetia, was charged with tax evasion, fraud, and illegal entrepreneurship. As he fled the country, he sold off his Russneft oil company (not to be confused with the state-owned Rosneft) to Oleg Deripaska, a tycoon known for his friendly relations with the Kremlin (Zarakhovich 2009). In 2008 a series of office raids, environmental inspections, and back tax claims against TNK-BP raised speculation that Gazprom was seeking to acquire control

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2 As discussed below, other aspects of the rule of law, such as political and human rights, suffered throughout the entire duration of the Putin regime.

3 The Khodorkovsky Affair has received a great deal of attention. Among other sources, see Goldman (2004).

4 Gutseriyev’s story ended on a positive note. He regained the Kremlin’s favor, his arrest warrant was canceled, and ultimately Deripaska, facing significant debts after the 2008 financial crisis, returned control of Russneft to Gutseriyev.
of yet another oil company (Belton 2008), but TNK-BP has so far remained independent.

These acquisitions transformed the oil sector. In 2000 majority state-owned companies produced 10 percent of oil output; by 2008, they produced 42 percent (Rutland 2009, 175). However, while the state has been active in other sectors, its tactics have not been nearly so coercive. In heavy industry, state-owned corporations have in recent years acquired major firms such as Silovye Mashiny, OMZ, and the auto manufacturer AvtoVAZ, but the type of pressure applied in the energy sector has not been present. In the financial sector, prominent backers of opposition political parties, such as Igor Linshits and Alexander Lebedev, have faced arrest and raids by tax authorities, but a massive transfer of assets to the state has not resulted. Nevertheless, the shadow of the Yukos Affair hangs over all major businesses: When in 2008 Putin accused the steel company Mechel of overcharging domestic consumers and issued what appeared to be a personal threat to the company’s chief executive, Mechel’s shares on the New York Stock Exchange dropped 38 percent for fear of an imminent state attack (Kramer 2008).

Yet evaluating these incidents is far from straightforward. Undeniably, they involved political calculations, the selective enforcement of the law, and abuses of the judiciary. Khodorkovsky had become a major funder of opposition parties and had publicized his plans to eventually run for president, in direct defiance of Putin’s warnings to the oligarchs to stay out of politics. Meanwhile, although the tax practices in which Yukos engaged were widely utilized by other major Russian oil companies, criminal charges were not directed at oligarchs who maintained cordial relations with the Kremlin. The prosecution of the Yukos Affair at times resembled a show trial. After six years in prison, Khodorkovsky, along with his associate Platon Lebedev, was brought to trial a second time. He and Lebedev were charged with embezzling billions of dollars worth of oil from Yukos, yet the amount they purportedly stole exceeded the company’s cumulative production for the period in question. Found guilty, it appears that Khodorkovsky may remain imprisoned well into the current decade. Many of Khodorkovsky’s defense lawyers themselves have faced trumped up charges and, in some cases, have endured harsh treatment. One was jailed for more than two years despite suffering from serious medical conditions; another, a mother of two young children, gave birth to her third child while still incarcerated after more than four years behind bars (Barry 2011; Meier 2011).

The simple fact remains, however, that Khodorkovsky, like nearly all of the oligarchs who accumulated wealth in the 1990s, almost certainly was guilty of numerous crimes. Although he had become a poster child for corporate governance reform in the immediate period prior to his arrest, for years he had been notorious for violating minority shareholder rights.

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5 Putin, speaking at an industry conference, said: “By the way, we invited the owner and director of [Mechel], Igor Vladimirovich Zyzin, to today’s meeting, but he suddenly got sick. . . . Of course, sickness is sickness, but I think Igor Vladimirovich should get better as quick as possible, otherwise we’ll have to send him a doctor” (Kramer 2008).
His close associates have faced investigations for, among other violent crimes, the murder of the mayor of Nefteyugansk, who had criticized Yukos for underpaying taxes (Goldman 2004). Consequently, in prosecuting such oligarchs, the line between the state’s legitimate enforcement of law and order and the illegitimate expropriation of private assets becomes blurry. Additionally, Khodorkovsky’s active lobbying against increased taxes in the energy sector, his promotion of independent oil pipelines, and his negotiations with American oil companies genuinely alarmed many within Putin’s administration, who perceived a risk to Russia’s sovereignty and control of its natural resources. For them, Khodorkovsky’s lobbying represented, in the words of one government official, “a danger and threat to the Russian state” (Cited in Goldman 2004, 38).

Attacks by high-level state officials are the type of expropriation that the classic literature on property rights most commonly depicts. Drawn from the history of the West, these studies often portray the struggle of property rights as a contest between a king and the business class (e.g., North and Weingast 1989). And, indeed, recent studies of property rights in Russia offer a similar depiction, framing the prospects for the rule of law as a game between Putin and a handful of powerful oligarchs (Guriev and Sonin 2009; Hoff and Stiglitz 2008). Yet, as noted above, outright expropriation by high-level government officials largely has been limited to the energy sector.

Indeed, when not seeking to reassert state control of strategic sectors deemed vital to Russia’s national security, Putin at many times, particularly in the early 2000s, seemed to be a sincere champion of improving the business climate and enforcing property rights. The liberal economist Andrei Illarionov, a Putin advisor until 2005, continued to insist that Putin’s reform efforts were sincere even after he had become an outspoken critic of the Putin regime: “In many cases, [Putin] was an instigator and initiator of reforms. He was very active in asking and requesting from his economic team what else [could] be done on stimulating economic growth…. He had a very strong feeling that reforms were necessary” (cited in Stewart 2008). Likewise, according to a representative of the business association OPORA, efforts to reduce the regulatory burden on small business were launched after Putin himself indignantly reacted to data in a newspaper article showing that registering a new business in Russia required far more days than in many Western countries (author interview, 19 March 2008). In 2005 Putin also put his personal clout behind a reduction in the statute of limitations on privatization-related crimes from 10 to three years, stating that “This will help the business community look into the future with greater certainty, draw up promising development plans and make new investments, and I hope reassure entrepreneurs over the security of property rights” (cited in Arvedlund 2005). Finally, while undoubtedly part of a plan to balance power among competing clans of elites, Putin’s choice of Dmitry Medvedev as his successor in the 2008 presidential elections placed a lawyer with well-known liberal leanings in a position of considerable influence.

It therefore warrants consideration that attacks by high-level state officials are just one
CHAPTER 6. FROM DEMAND FOR LAW TO THE RULE OF LAW

Table 6.3: Average Number of Inspections by Government Agencies
(Per six-month period)

<table>
<thead>
<tr>
<th></th>
<th>Second half of 2001</th>
<th>First half of 2002</th>
<th>Second half of 2002</th>
<th>Second half of 2003</th>
<th>Second half of 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax</td>
<td>0.74</td>
<td>0.53</td>
<td>0.53</td>
<td>0.49</td>
<td>0.48</td>
</tr>
<tr>
<td>Fire</td>
<td>0.90</td>
<td>0.63</td>
<td>0.54</td>
<td>0.48</td>
<td>0.46</td>
</tr>
<tr>
<td>Sanitary</td>
<td>0.70</td>
<td>0.51</td>
<td>0.47</td>
<td>0.35</td>
<td>0.32</td>
</tr>
<tr>
<td>Police</td>
<td>0.57</td>
<td>0.37</td>
<td>0.35</td>
<td>0.28</td>
<td>0.28</td>
</tr>
</tbody>
</table>

Source: Shetinin et al. (2005, 5)

relatively limited aspect of the predatory state. For the majority of firms, the most pressing concern is harassment from lower-level officials, whom the top leadership — even when sincerely seeking to improve the business climate — struggles to control in a country as vast as Russia. The harassment and persecution firms face from bureaucrats and law enforcement officials in many ways resembles the property security strategies based on corrupt force that were analyzed in Chapter 2. But there is one fundamental difference: State officials are increasingly initiating attacks on firms themselves rather than merely offering property security services to private actors.

6.5.2 Harassment from Lower-Level Bureaucrats

A key element of a predatory state is that bureaucrats create or maintain excessive regulations, which force firms to pay bribes in order to cut through red tape, acquire necessary permits, or avoid fines and sanctions. Particularly cognizant of the regulatory burden faced by smaller firms, the Russian government initiated significant reforms in the early 2000s. A law on inspections, which took effect in August 2001, limited the number of planned inspections of a particular firm by any one government agency to no more than one every two years and created stricter procedures for permission to conduct “unplanned” inspections (i.e., inspections of firms suspected of violating laws). A law on licensing, which came into force in February 2002, dramatically reduced the number of activities requiring licenses or certification, lowered the maximum price of licenses, and extended the legally-mandated minimum term of a license’s validity. Finally, in July 2002 a law on the registration of new businesses placed a maximum price on registration, mandated that the registration process should not exceed five days, and established a “one window” rule such that a firm should not have to visit more than one government agency during the process of registration.

The Center for Economic and Financial Research in Moscow (CEFIR), in conjunction with
the World Bank and USAID, monitored the effects of the reforms for several years after implementation using surveys of 2000 small businesses from 20 regions. The results demonstrate that the reforms had a significant one-time effect, but that after the initial reduction in regulatory burdens, bureaucrats were able to stall reforms well short of legally mandated goals. Table 6.3 shows the average number of inspections by several key government agencies per six month period. Overall, the average number of inspections firms faced in the first half of 2002 was 33 percent lower than the average number faced in the second half of 2001 (Shetinin et al. 2005, 5). Yet progress tapered off thereafter. Moreover, agencies continued to violate the law’s ban on repeat inspections during a two-year period. In 2004, of firms inspected by the police, over 40 percent reported a repeat visit; fire inspectors and tax inspectors likewise returned to around 20 percent of firms which had already faced recent inspections. The law also seemed to have a minimal effect on unplanned inspections, which in 2004 constituted more than half of all police inspections and around one-third of fire and tax inspections. CEFIR further found that for many agencies, more than half of their unplanned inspections were conducted without warrants, in violation of the law (Shetinin et al. 2005, 6).

The effects of the laws on licensing and registration were similar. Following the introduction of the licensing law, the share of firms applying for licenses fell from 31 percent in the second half of 2001 to 14 percent by the second half of 2004, showing a reasonable amount of deregulation of economic activity. Yet by the mid-2000s, more than approximately half of all licenses remained illegitimate, in that they were issued for activities that by law do not require licensing (Shetinin et al. 2005, 7). More success was observed with respect to the law on registration. Whereas prior to the new law, a mere 20 percent of firms were able to register in less than a week, by 2004, nearly half of firms managed to do so (Shetinin et al. 2005, 9). Yet despite the progress, these figures indicated that half of all firms were still facing delays longer than the legally mandated five-day period.

A follow up survey conducted by CEFIR in 2009 found that the burden imposed by inspections, licensing, and registration remained largely unchanged since the mid-2000s (Bessonova et al. 2010). Indeed, during interviews conducted by the author throughout 2009, businesspeople, especially owners and managers of small firms, regularly referred to bureaucrats as the primary threat to the security of their assets — a threat more destructive than the banditry of the 1990s. In the words of a consultant to small businesses in Moscow: “Who cares

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6 CEFIR’s spring 2002 baseline study was conducted prior to the implementation of the licensing and registration laws, but not prior to the implementation of the inspection law. Their baseline survey, however, asked firms to report on the number of inspections both in the first half of 2001, before the law on inspections came into effect, and in the second half of 2001. The change in inspectors’ behavior appears to have been delayed, showing up not in the comparison between the first and second half of 2001, but in the comparison between the second half of 2001 and the first half of 2002, as indicated in Table 6.3.

7 These figures refer to firms that did not hire a consulting firm or other type of intermediary to help with the registration process.
6.5.3 Pressure from Law Enforcement Officials

While regulatory officials can slow a firm’s operations or potentially shut down a firm, the most fearsome threats are those posed by law enforcement officials. In such raids, officials usually charge or threaten to charge entrepreneurs with criminal prosecution in order to force firms to pay bribes or to sell off assets at below market prices. For cooperative entrepreneurs, the charges may never materialize. For others, the fear of imprisonment may induce cooperation, after which charges are dropped. For the most recalcitrant, the authorities make use of judges’ willingness to allow pre-trial detention without bail for extended periods of time, even for non-violent crimes. Although such raids are by no means a new invention, Russian businesspeople widely perceive the aggressiveness of law enforcement offi-
cials to have increased after the Yukos Affair. In the words of Yana Yakovleva, the founder of *Biznes Solidarnost*, an association dedicated to aiding entrepreneurs who have been wrongly imprisoned, every official after 2003 was looking for his “own little Yukos” (author interview, 22 October 2009).

When authorities attack larger firms, such raids can be high-profile, as was the case in the affair of the mobile-phone retailer Evroset. Evgeny Chichvarkin and his business partner, Timur Artiemev, founded the company in 1997. The company’s growth was explosive. By 2002, they had become one of the top retailers in Moscow; by 2007, using a franchising business model, they had over 5,000 outlets throughout the former Soviet Union. Such lucrative assets fell under the gaze of the authorities. Beginning in 2005, Evroset clashed with law enforcement officials, who claimed the company was selling illegally imported contraband. In 2006 Evroset fought back, pressing charges against Ministry of Interior officials who had wrongfully confiscated Evroset merchandise and then unlawfully destroyed some of the assets before returning them to the rightful owners. The case resulted in hefty fines and, ultimately, a jail sentence for several officials involved. Thereafter, Evroset faced several rounds of police raids on its offices, which many observers viewed as retaliation for their bold challenge to the authorities. Various members of Evroset’s internal security service were then charged with kidnapping and extortion of a former employee whom they had suspected of embezzlement. By 2008, the authorities had managed to implicate Chichvarkin himself in the affair, and he fled to London after selling his assets (Walker 2010).

Chichvarkin is hardly the only entrepreneur to have run afoul of the authorities. Yakovleva, the *Biznes Solidarnost* founder, herself spent more than half a year in jail after refusing to pay bribes when her chemical company was charged with selling illegal substances. Since her release, the organization she founded has helped publicize the plight of dozens of similar cases. Data on economic crimes offer evidence of the scale of law enforcement raids. Favored charges used to apply pressure on firms include fraud (Article 159 of the Criminal Code), misappropriation or embezzlement (Article 160), money laundering (Article 174), and a range of other charges related to what in Russia are called “economic crimes” (Volkov et al. 2010, 5-6). Unlike crimes such as murder or theft, which are reported to the police by citizens, these economic crimes require proactive investigation by legal authorities, providing officials with significant discretion to probe a wide range of firms. As can be seen in Table 6.5, after 2003, the initial year of the Khodorkovsky Affair, there was a notable increase in the number of economic crimes uncovered by Ministry of Interior investigators: Between 2003 and 2004, fraud- and embezzlement-related cases, which since the late 1990s had remained relatively constant, increased nearly 15 percent. The number of money laundering cases nearly doubled and then continued to skyrocket as the decade proceeded.

Interpreting crime statistics, of course, presents many challenges. An increase in the number of recorded crimes can result from a crime wave, more aggressive policing of genuine criminal activity, or, in the post-communist world, an increase in abuse of the Criminal Code. To
Table 6.5: Number of Economic Crimes Reported, 2000-2010

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fraud</td>
<td>47.8</td>
<td>46.2</td>
<td>45.7</td>
<td>47.5</td>
<td>54.1</td>
<td>58.5</td>
<td>66.1</td>
<td>69.5</td>
<td>75.0</td>
<td>78.3</td>
<td>58.2</td>
</tr>
<tr>
<td>Embezzlement</td>
<td>51.1</td>
<td>51.0</td>
<td>47.4</td>
<td>44.7</td>
<td>51.6</td>
<td>52.4</td>
<td>50.3</td>
<td>56.6</td>
<td>46.8</td>
<td>40.0</td>
<td>23.5</td>
</tr>
<tr>
<td>Money laundering</td>
<td>1.8</td>
<td>1.4</td>
<td>1.1</td>
<td>0.6</td>
<td>1.8</td>
<td>7.5</td>
<td>8.0</td>
<td>9.0</td>
<td>8.4</td>
<td>8.8</td>
<td>1.8</td>
</tr>
</tbody>
</table>

Source: Rosstat and RF Ministry of Interior.

address this issue, Volkov et al. (2010) conducted an innovative analysis in which they examined the percentage of reported crimes that actually led to a court sentence. Honest law enforcement officials usually prefer not to initiate cases with a low likelihood of being brought to fruition, for a high number of cases that fail to lead to prosecution affects the indicators on which promotions are based. On the other hand, officials who are seeking to apply pressure on firms will be more likely to initiate cases that lack merit, simply as a means of frightening entrepreneurs. Volkov et al. found that in 2007, only 10 to 15 percent of cases relating to fraud and embezzlement resulted in sentencing, in stark contrast to murder and rape, which once initiated, led to sentencing in 90 percent and 75 percent of cases, respectively. While recognizing that the complexity of economic crimes creates legitimate challenges for investigators, leading them to drop some cases, they concluded: “The basic proposition supported by the data is that a significant part of criminal cases related to economic crimes are initiated and carried out in connection with the commercial interests of the law enforcement agencies” (Volkov et al. 2010, 15).

The abuse of the criminal code to pressure entrepreneurs has become grave enough to attract attention at the highest levels. In April 2010, Medvedev signed a law prohibiting the pre-trial detention of businesspeople accused of fraud, embezzlement, or the damage of property by deceit or breach of trust. It is too early to evaluate the effects of the law, although the number of recorded economic crimes did fall drastically in 2010, as seen in Table 6.5.

6.6 A Final Word

Whether secure property rights take root in Russia will depend on the outcome of the clash between two countervailing tendencies: the private sector’s rising demand for law on the one hand and the increasingly predatory state on the other. And even if the rule of law triumphs in the economic sphere, Russia will still face significant challenges. Secure property rights do not guarantee other fundamental aspects of the rule of law, such as human rights, freedom of the press, and the accountability of political leaders. Yet arguably, demand for law in the economic sphere may have a far-reaching impact through spillover effects. First, demand for law by businesspeople may be a stepping stone for broader societal demand for law. Victims of property rights violations have a direct material incentive that may provide a stronger stimulus for action than that which results from violations of political, social, or human rights. Moreover, an emerging capitalist class possesses the resources to react to violations of its rights (Hendley 1996). Once demand for law is established for some spheres of society, this may provide a blueprint for legal action that spreads to other spheres. Second, once legal doctrine is established in one realm, it may spread to others. For example, the doctrine of substantive due process in the United States emerged from the due process clauses of the Fifth and Fourteenth Amendments originally with respect to protection of property rights, but ultimately came to be used to protect rights as diverse as the right to travel or the right to marry across racial lines (Silverstein 2003).

It remains to be seen whether the spillover effects of private sector demand for law will have a positive effect on society and politics more broadly, or whether other negative developments will eventually overwhelm the demand for law. The barriers to the rule of law in Russia remain severe. Yet when one considers the chaos and lawlessness of the 1990s, the fact that firms today regularly turn to courts and lawyers represents a significant step in a positive direction.
Appendix A

Interviews

Ninety semi-structured interviews were conducted by the author throughout 2009. The breakdown across firms, lawyers, and private security agencies is presented in Table A.1. Seventy-seven interviews were conducted in Moscow; the remaining interviews were conducted in Barnaul. Seventy-five of the respondents were Russian; the other 15 were expatriates with extensive business experience in Russia. Thirty-six supplementary interviews were conducted with business journalists, academics, non-governmental organizations, and business association representatives.
Table A.1: Characteristics of Interview Respondents

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Total Interviews</td>
<td>90</td>
</tr>
<tr>
<td>Firms</td>
<td>56</td>
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<tr>
<td>of which</td>
<td></td>
</tr>
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<td>&lt;15 employees</td>
<td>15</td>
</tr>
<tr>
<td>15 to 100 employees</td>
<td>12</td>
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<td>101 to 250 employees</td>
<td>12</td>
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<tr>
<td>&gt;250 employees</td>
<td>17</td>
</tr>
<tr>
<td>Lawyers</td>
<td>22</td>
</tr>
<tr>
<td>Private Security Agencies</td>
<td>12</td>
</tr>
</tbody>
</table>
Appendix B

Survey

The survey sample consists of 301 manufacturing and service firms from Moscow, St. Petersburg, and six regional cities: Ekaterinburg, Nizhniy Novgorod, Samara, Novosibirsk, Rostov-on-Don, and Kazan. Firms were selected using stratified random sampling. As shown in the sampling matrix in Figure B.1, the stratification was conducted to ensure that the sample would include a sufficient number of micro, small, medium, and large firms, as well as a sufficient number of firms in Moscow, St. Petersburg, and regional cities. Each cell was further divided evenly between manufacturing and service firms. Figure B.2 displays the distribution of respondents by firm size and city for the actual sample.

The response rate for the survey was 41 percent. Survey-related interviews were conducted face-to-face during June and July 2010 by interviewers from the Russian survey-research firm Bashkirova and Partners with either the firm’s owner, general director, deputy general director, or chief financial officer. All questions were close-ended.
Figure B.1: Sampling Matrix

<table>
<thead>
<tr>
<th># of employees</th>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
<th>Very Large</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>St. Petersburg</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>10</td>
<td>75</td>
</tr>
<tr>
<td>Regional</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>30</td>
<td>125</td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>60</td>
<td>300</td>
</tr>
</tbody>
</table>

Figure B.2: Distribution of Respondents by Firm Size and City

<table>
<thead>
<tr>
<th># of employees</th>
<th>Micro</th>
<th>Small</th>
<th>Medium</th>
<th>Large</th>
<th>Very Large</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow</td>
<td>16</td>
<td>19</td>
<td>21</td>
<td>23</td>
<td>22</td>
<td>101</td>
</tr>
<tr>
<td>St. Petersburg</td>
<td>11</td>
<td>15</td>
<td>16</td>
<td>16</td>
<td>17</td>
<td>75</td>
</tr>
<tr>
<td>Regional</td>
<td>22</td>
<td>22</td>
<td>28</td>
<td>26</td>
<td>27</td>
<td>125</td>
</tr>
<tr>
<td>Total</td>
<td>49</td>
<td>56</td>
<td>65</td>
<td>65</td>
<td>66</td>
<td>301</td>
</tr>
</tbody>
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citizens have been arrested on suspicion of committing a crime by the officers of the extra-
departmental guards of the Russian MVD].  


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