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***Law, Relationships, and Private Enforcement:
Transactional Strategies of Russian Enterprises***

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Summary

What role do laws and legal institutions play in business relations in Russia? The mass media and much of the scholarly literature would have us believe that a Wild West atmosphere prevails in the former Soviet Union in which businesses routinely rely on the mafia to enforce their contracts and in which the existing laws and legal institutions are grossly inadequate. In this paper, we undertake a systematic evaluation of how Russia firms do business with one another, paying particular attention to the mechanisms employed when difficulties arise. In contrast to the popular myths, we find that the catalog of strategies is as comprehensive in Russia as in any other country, with trust emerging as a critical ingredient in sustaining good relations among trading partners. We find little support for claims that Russian firms are heavily dependent on the mafia for contract enforcement or that Russian firms shy away from the courts. Our data on Russia provide extensive evidence pertinent to current academic debates on the relative importance of trust and contract, relationships and courts in supporting productive business relations.

Law, Relationships, and Private Enforcement: Transactional Strategies of Russian Enterprises

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Abstract

We examine how Russian enterprises do business with one another, focusing on the strategies used to obtain efficiency and predictability in their transactions. Using survey data, the paper analyzes the relative importance of relational contracting, self-enforcement, enterprise networks, private security firms, administrative institutions, and courts. Enterprise-to-enterprise negotiations are preferred, but courts are used when disputes resist resolution through negotiation. Consistently, little evidence suggests enterprises resort to private enforcement, indicating overstatement in the supposed connection between weakness in law and the mafia's rise. Legacies of the old administrative enforcement mechanisms are few, although enterprise networks from Soviet days remain resilient.

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Introduction

The efficiency and predictability that firms desire in their business relations have many different sources. A traditional perspective embodied in the classical view of contracting and implicitly in the general equilibrium model of neo-classical economics saw a world of arm's length trading supported by powerful state legal institutions.¹ Similarly, an evolving state capacity to enforce contracts is an essential element of North's (1990) description of the rise of the west and the process of economic development.²

An alternative view was stimulated most notably by Macaulay (1963) and spurred by developments in transactions-cost analysis (Williamson, 1985) and game theory (e.g. Telser, 1980 and Kreps et al., 1982). The alternative view maintains that the importance of law in contractual relations has been vastly overstated and that economic agents construct productive relationships largely without reference to the legal system.³ To support economic relationships, agents use a variety of purely private mechanisms such as personal trust, calculative trust, reputation, and constructed mutual dependence.⁴ Stated provocatively, the fundamental difference between the traditional and alternative views subsists in the relative roles of trust and law in promoting cooperation (Deakin, Lane, and Wilkinson, 1997).

In more sociological analyses, a common theme is that personal interaction and impersonal state institutions tell only part of the story (Greif, 1996). Relationships are embedded in a

¹ Williamson (1985, p. 20) refers to this as the legal centralist point of view in which "Most studies of exchange assume that efficacious rules of law regarding contract are in place and are applied by the courts in an informed, sophisticated, and low-cost way." Legal scholars tend to refer to it as the classical or neoclassical theory of contracts. (E.g., Macaulay, 1977, pp. 508-10; Feinman, 1990, pp. 1285-87)

² Weber's (1967) historical-theoretical analysis of the rise of capitalism in Western Europe focuses on the importance of private property as an impetus for merchants to rely on law. As Macaulay (1977, pp. 509-10) argues, Weber assumes that law and litigation are integral to contract enforcement.

³ A host of studies could be cited here, some of which have as their central thesis that the legal system is irrelevant and others which take this thesis as an assumption while showing the alternative mechanisms that transactors use to support their relationships. For an example of each of the genres, see Macneil (1985) and Klein and Leffler (1981).

⁴ This is not the place for an extended discussion of "the elusive notion of trust" (Gambetta, 1988, p. ix). In the following, we will maintain the distinction developed by Williamson (1993) between calculative trust and personal trust. Calculative trust between two parties occurs when each of the parties calculates that it is in the other party's own interest to cooperate, basing that calculation on a systematic exploration of each party's goals and possibilities. In contrast, personal trust is closer to a human passion, in which the two parties have an implicit agreement not to calculate, not to monitor closely, since either of these would destroy the presumption that each party assumes that the other party has good intentions in the conduct of the joint relationship. As will be made clear in later sections, personal trust and calculative trust correspond to two different transactional strategies. Our discussions of trust do not refer to citizens' attitudes toward the government. See generally Mishler and Rose (1997).

broader social structure (Evans, 1995; Granovetter, 1985). Social, or network, relations affect the nature of the interaction between trading parties and provide powerful enforcement mechanisms when the potential for disputes arises (Galanter, 1974). Relationships are supported by community reputation and by the costs and benefits of information exchange. This group- or network-oriented approach has been increasingly popular in the last decade,⁵ spurred by the recognition of the importance of networks of traders in such varied settings as East Asia⁶ and New York (Bernstein 1992, Uzzi 1996), and by the historical-theoretical analysis of Greif (1989, 1994; see also Greif, Milgrom, and Weingast, 1994) and North (1990; see also, Milgrom, North, Weingast, 1990).

The relative importance of each of these mechanisms of governing relationships is still an open question, as is their variation in importance across situations and societies. Indeed, there is so little consensus that Williamson (1994, p.174) identifies an "...exaggerated emphasis on court ordering (by the institutions of the state) over private ordering (by the immediate parties and affiliates to a transaction)..." while Deakin, Lane, and Wilkinson (1997, p. 105) observe "...a wide consensus to the effect that the institutions of contract law are largely marginal to the processes of business contracting." Similarly, in the economics literature one frequently encounters the assumption that contracts are not enforceable by the government or any other third party (Klein and Leffler, 1981, Klein, 1996) while legal scholars tend to assume a more central role for law and legal institutions in contractual matters.⁷

The paucity of detailed empirical information that has driven these schizophrenias is also the major impetus for this paper. While Macaulay's (1963) seminal empirical findings are credited with producing a sea change in views of the role of contract, his "preliminary study" is usually the only one cited as providing empirical support for this newer perspective.⁸ As

⁵ Landa (1994, p. 101) calls the "ethnically homogenous middleman group" an "institutional alternative to contract law."

⁶ Writing about contemporary China, Jones (1994, p. 216) refers to the "the role of guanxi networks as an alternative to the legal regulations of exchange." See also Winn, 1994.

⁷ An evaluation of the competing theories of contract law is beyond the scope of this article. Feinman (1990) and Hillman (1997) provide comprehensive critical assessments.

⁸ Esser (1996) and Deakin, Lane, and Wilkinson (1997) represent recent attempts to pursue the same lines of empirical enquiry.

Hillman (1997, p. 246) observes, there is “a dearth of new studies testing Macaulay's thesis.” There do exist important studies of specific markets and specific contractual practices (e.g., Bernstein 1992, Masten 1996), but these studies do not catalog the whole spectrum of transactional strategies in a way that would lead to a judgment on which strategies are most important. Broader perspectives are provided by Soto (1989) and McMillan and Woodruff (1998), who examine the role of relationships and networks in contracting outside the law in Peru and Vietnam, respectively, and Fafchamps, who analyses enforcement of commercial contracts in Ghana (1996a), the importance of relationships for traders in Madagascar (1998), and the enforcement of trade credit contracts in Zimbabwe (1996b). Our objective is to broaden the analysis even further by cataloging the relative importance of each element of the entire set of strategies available to businesses as they seek cooperative transactional arrangements.

We provide an overview of how contractual relations are governed in Russia's nascent market economy, using both quantitative and qualitative information. We reflect on the significance of relational contracting, self-enforcement mechanisms, social networks, and legal institutions. We also consider the extent to which the legacies of the Soviet-era planned economy continue to affect inter-enterprise relations given that, less than a decade ago, contracts were enforced primarily through administrative levers. Our objective is to fill the empirical lacuna on the sources of contract governance by systematically presenting information on the use of all the major strategies available to enterprises and by making judgments on which of those strategies seem most important.

Russia presents an intriguing case. Under the old system, legal institutions were highly permeable. Laws bent to the political winds, as did the courts (Hendley, 1996). In view of this history and the difficulty of quickly legitimizing carryover legal institutions, many commentators have argued that law is not terribly relevant in the emerging Russian market and that the shortcomings of the legal system are a key factor stymying development. (E.g., McFaul, 1995, pp. 95-96; Åslund, 1995, pp. 5-7, 138; Eckstein et al. 1998, p. 146; Ernst et al. 1996, p. 292.) Some take this argument much farther and contend that enterprises are turning to private security firms for assistance, and that these firms are performing state functions (Leitzel, Gaddy, and Alekseev, 1995; Shelley, 1995, p. 830; Hay, Shleifer, and Vishny, 1996). Thus, we examine

whether these security firms -- the mafia of popular lore -- are important in Russian contractual relations.

Our data indicate that, much like their Western counterparts, Russian enterprises use a wide variety of mechanisms to govern their contractual relations. Russian enterprises exhibit a strong preference for using direct enterprise-to-enterprise negotiations to solve potential contractual problems. Similarly, there is a reliance on long-term partners, suggesting that personal trust plays an important role in ensuring stability. This is hardly surprising given the chaotic nature of the contemporary Russian marketplace, and the difficulty of assessing the credibility of potential trading partners.

Contrary to common wisdom, Russian enterprises do not reject the use of law and legal institutions when disputes arise.⁹ Many enterprises use the courts. This is not to say that a legalistic strategy is preferred, but merely that such a strategy is considered feasible, given that information on trading partners is scarce and breach is commonplace. Consistently, we found little evidence of enterprises resorting to private law enforcement. These findings suggest that the supposed connection between the ineffectiveness of law and the rise of the mafia is overstated. Finally, the legacies of the old administrative enforcement mechanisms seem few, although the enterprise networks built up during the Soviet days are rather resilient.

In the following section of the paper, we briefly examine the available transactional strategies, setting up the framework for our presentation of the data. We go on to describe the source of the information we use, the primary element of which is a survey of 328 Russian enterprises. The following section catalogs the prevalence and the effectiveness of the various transactional strategies available to Russian enterprises. We then analyze complementarities between the use of the different strategies, an analysis that provides important clues about the sources of institutional change in Russia. A conclusion summarizes the lessons emanating from the paper, lessons on the nature of present-day Russia and more general ones on the nature of transactional strategies in market economies.

⁹ A detailed discussion of the relevance of law and legal institutions to the process of negotiating the terms of business deals is beyond the scope of this article, but we do provide some examples in presenting our empirical information.

The Available Transactional Strategies

What alternative strategies could Russian enterprises pursue in search of efficiency and predictability in their business relations with other enterprises? In this section, we describe a set of seven strategies, which we consider to cover the broad range available. For expositional convenience, we place these strategies on a spectrum, with reliance on relationships at one end and reliance on law at the other.¹⁰ The ordering of points on the spectrum roughly correlates with variations in some of the properties of the strategies, such as reliance on reputational effects or the involvement of official third parties. Nonetheless, we cannot emphasize too strongly that we do not view enterprises as moving up or down the spectrum in a linear fashion, as they change their approach to ordering relationships. Certain elements of the spectrum might be unavailable to some enterprises; some enterprises might find that abandoning a strategy at one end of the spectrum will force them to move to the other end. Moreover, any given enterprise will likely use a combination of transactional strategies.

Table 1 sets forth the seven basic strategies, along with examples drawn from present-day Russia and plausible values for the properties of strategies. The Table is intended to serve as a framework for discussion. It mirrors our empirical information in focusing on what enterprises do to prevent or to solve problems in existing relationships. This is, of course, only one part of making relationships work. There are also the formative steps, for example, the setting of contractual terms or the choice of customers and suppliers. We do provide information on some formative issues below, but this is not the heart of our empirical information. Our focus is on the enterprise's approach to problem-solving, as one lens through which we can understand the more general phenomenon of how enterprises make their relationships work.

At one end of the spectrum is *relational contracting*.¹¹ When two enterprises trade with one another over an extended period, their officials might develop deep bonds of personal trust that override any nagging fears of contractual non-performance. Then, the relationship no longer

¹⁰ Macaulay et al. (1995, p. 235) conceptualize contracts as existing "on a spectrum from discrete transactions to long-term continuing relations." See also Galanter (1974).

¹¹ See Macneil (1985). Schwartz (1992) suggests that relational contracting refers to the same phenomenon as the notion of incomplete contracts in economics.

depends upon a detailed calculus of the motives of the other party. In such cases, the written contract is largely superfluous (Macaulay, 1963). Any specific element of agreement between the two parties can only be understood in the context of the totality of the relationship. If problems arise, they are resolved through negotiations, without involving outsiders. Adjustments occur without recontracting. Resorting to the courts or even bringing in lawyers can be corrosive, since such actions signal a defraying of personal trust.

In *self-enforcement*, the relationship is based on the calculus of mutual interest, each party deciding that the other has a self interest in fulfilling the agreement.¹² This is a relationship of calculative, rather than personal, trust. However, a succession of self-enforcing agreements might lead to the development of personal trust. Hence, in practice, the borderline between relational and self-enforcing agreements is fuzzy.¹³

In self-enforcing arrangements, the contract determines outcomes. Since parties are expected to be calculating, lawyers may play a more significant role than under relational contracting and going to court need not necessarily signal the end of all future interactions. Nevertheless, self-enforcing agreements most often arise in situations where use of the official legal system is not envisaged. The threat of stopping trade is the basic enforcement mechanism. The parties also build in conditions that encourage performance.¹⁴ (Later in the paper, we discuss how Russian enterprises use barter and pre-payment to this end.)

When the relationship between two parties is embedded in a wider network of relations, *third-party enforcement* occurs.¹⁵ The network can provide benefits to the two parties, for example, through an elevation in social status or by sharing information about trading partners. It can also impose costs such as the shame of being branded as untrustworthy or the lost profits

¹² See Telser (1980) for example.

¹³ Indeed, being worthy of personal trust might be operationally indistinguishable from having a reputation for fair dealing and being receptive to complaints. In one description of the process of building a relationship, the parties interact and then social and psychological factors lead to personal trust. In another description, when interacting the parties have an incentive to build a reputation as a good partner and they do so in a calculating manner. The only factor that might distinguish the two types of processes is the pattern of thought that leads to behavior.

¹⁴ See for example Williamson's discussion of hostage models (1985, Chapters 7 and 8.)

¹⁵ The term is taken from Greif (1996, pp.246-47). He also uses the term "collectivism," but given the history of Russia use of this term would create much confusion in the present paper.

from foreclosed trading opportunities with network members. These benefits and costs provide the carrot and stick that can induce contract fulfillment between two network members. This mechanism represents a step away from self-reliance, but does not yet presume state involvement or extra-legal remedies of self-help. An example of the implementation of this strategy would be informing other enterprises about the poor performance of a trading partner.

Private enforcement occurs when the parties to a contract use the services of a private entity that does not have any pre-existing relations with them. The standard example in developed economies is the inclusion of arbitration clauses in commercial contracts. In transition economies, private enforcement also brings to mind uglier mechanisms, such as calling upon the mafia or a private security firm to secure performance by a trading partner. Such enforcement assumes a lack of confidence both in the trading partner and in the capacity of the legal system to provide acceptable relief, although private enforcers may simply implement judgments of the courts. This strategy is typically one that is multi-layered, often beginning with implicit threats, and sometimes culminating in the use of violence. While violence is not an essential element, intimidation is.¹⁶

Enforcement could be provided by any entity that can impose costs or bestow benefits on the contracting parties. Given the history of state involvement in Russia's economy, an obvious suspect for that role would be the *state administration*.¹⁷ Enterprises that are still close to the state would naturally ask government officials to pressure a trading partner who is not performing. Governments have many levers of influence over enterprises (both official and unofficial) and, depending on the circumstances, may be willing to use them. Presumably, the non-performing enterprise will change its behavior rather than risk the state's ire.¹⁸ Also, during reforms, a number of new administrative agencies have been created that are empowered to deal

¹⁶ If the intimidation and violence is provided by the private armies of one of the contracting parties, then this would be classified as self-enforcement.

¹⁷ State bodies also provide such services in market economies, the prototypical case being a local official mediating between a developer and a construction company.

¹⁸ Sometimes the punishment comes not from the state directly, but from a private entity responding to pressure from the state. For example, the state (in some capacity) might convince the enterprise's bank to call its loans.

with enterprise complaints about violations of certain laws by others. We are interested in the extent to which Russian enterprises are taking advantage of these new opportunities.

As we approach the other end of the spectrum, law plays a central role. Often, the role can be as mere backdrop: the possibility of a credible threat to use the courts will be enough to establish an important role for legal rules in determining the character of outcomes. The threat induces the parties to bargain to agreement within the *shadow of the law* (Mnookin and Kornhauser, 1979; Jacob, 1992; Cooter et al., 1982). When relations between trading partners are characterized by a low level of trust, their contracts often include confiscatory remedies designed to protect the parties. Examples of these are collateral arrangements or penalty clauses. In case of default, correspondence between enterprises would include threats to initiate lawsuits and to enforce these confiscatory contractual terms. Settlement comes because it is cheaper than litigation, not out of any desire to protect a reputation or to maintain a relation with a long-term business partner.

At the opposite end of the spectrum from relational contracting is *litigation*. Submitting a dispute to the courts implies an acceptance of the legitimacy of the institution, and a willingness to abide by its decision (Shapiro, 1981). Filing a lawsuit typically indicates a breakdown in the relationship between the trading partners. They would not appeal to court, given litigation costs, if settlement could be reached through negotiation. In a stable economy, litigation is also expensive in relationship terms. Harsh words are exchanged, and the trading relationship is often irretrievably severed.

The Survey and the Data

Between May and August of 1997, we surveyed 328 Russian industrial enterprises with the aim, inter alia, of understanding how they conducted their business relationships. The sample included enterprises from six cities (Moscow, Barnaul, Novosibirsk, Ekaterinburg, Voronezh, Saratov), with each city represented roughly equally. The enterprises were concentrated among nine industrial sectors.¹⁹ Enterprise size ranged from 30 to 17,000 employees, with a median of 300 and a mean of 980. Most of the enterprises were established during the Soviet era, and about

¹⁹ The industrial sectors are (number of enterprises in parentheses): food processing (67); textiles, clothing and leather (60); fabricated metal (34); electronics (34); chemicals and petroleum (33); construction (18); wood products (8); paper and printing (5); and other (46).

three-fourths (77%) are privatized. In virtually all of those privatized, some stock was in the hands of insiders, and nearly a third were entirely owned by insiders. Outsiders (non-employees of the enterprise) held some stock in 60% of the enterprises.

In each enterprise, Russian surveyors administered different survey instruments to four top managers: the general director, and the heads of the sales, purchasing (supply), and legal departments. In this paper, we focus primarily on the data reported by the heads of the sales and the purchasing departments.²⁰ Our discussion centers on the answers to two composite questions, one addressed to each of these two enterprise officials, focusing on how the enterprises deal with problems, potential or actual, in contractual relationships.²¹ Since each of the seven strategies outlined above involves distinctive approaches in dealing with problems, these answers provide us with basic information on the use of each strategy. In Boxes 1 and 2, we reproduce English versions of the questions as they were addressed to enterprise officials.²²

The structure of the questions was partially determined by the desire to maximize the amount of information collected in the face of constraints on respondents' time. We wanted to examine both the strategies that were used to prevent the occurrence of problems and the strategies used to deal with partners that did not perform. We also wanted to explore both sales and purchasing transactions. With infinite respondent patience, which we did not have, this would have dictated four composite questions. Instead, we settled for two: the purchasing question dealing with the prevention of problems and the sales question dealing with non-performance. This match was natural in the present Russian transactional climate, given that non-payment of contractual debts is rife.²³

²⁰ When the enterprise did not have a formal department, the person who carried out the relevant duties in the enterprise answered the survey.

²¹ We use responses to other survey questions to expand on the information from these two composite questions.

²² There is a small change in format from the Russian versions, in order not to confuse the reader with the instructions given to the surveyors.

²³ The national-level statistics on *arbitrazh* court caseload provide one indicator of the growth of non-payments as a problem. In 1992, such cases made up 19% of the total cases decided. By 1995, they had grown to constitute the majority (51%) of cases decided. (Sudebno-arbitrazhnaya statistika, 1997)

In constructing the question posed to the purchasing department (Box 1), we assumed that a potential for disputes in contractual relationships always exists and that the means of addressing that potential are indicative of the transactional strategy undertaken. Thus, we listed twelve methods of presenting and resolving problems, and asked enterprises whether they used the method and how they rated the effectiveness of the method on a scale of 0 to 10.

Table 2 summarizes the responses to the question reproduced in Box 1. In column (1), we associate each method of addressing potential disputes with one of the strategies on the spectrum summarized in Table 1. Column (2) lists the percentages of enterprises that use each method. Column (3) summarizes the enterprises' evaluation of the effectiveness of each method by presenting the mean scores of the 0 to 10 scale, including only the responses of the enterprises that used the method. The final column combines the information on extent of use and effectiveness. Assuming that the effectiveness of a method is 0 for those enterprises that did not use it, one can calculate a mean effectiveness score across all enterprises. These mean scores appear in the fourth column.

The question posed to the sales department (Box 2) focused on the actions taken when customers did not honor their agreements. The responses are presented in Table 3, whose construction is identical to that of Table 2. Given that non-performance is a presumption of the question, it is appropriate to list methods that are more ominous than those addressed on the purchasing side (e.g., "stopping trade," "reporting...." "filing..."). But these stronger methods might be very effective as threats alone and therefore the question includes the possibility that the threat of use, rather than the actual use, is the method of dealing with non-performing customers. In turn, this led to the necessity of posing a different set of methods in the customer question than in the purchasing question. (The threat of a meeting sounds hardly credible!) For these methodological reasons, the questions posed in Boxes 1 and 2 are not identical. Each addresses a part of the picture of the transactional strategies of Russian enterprises.

How do we view the estimates contained in these Tables? Given the constraints of survey procedures and the essentially qualitative nature of the phenomenon with which we are dealing, the numbers presented should be regarded as crude indicators. But this imprecision has to be taken in the context of the limited amount of information that exists on the relative importance of

the different transactional strategies that enterprises undertake. This statement is as true for developed market economies as it is for Russia. Thus, we view Tables 2 and 3 as shedding a glimmer of light on territory where the rays of the accountant, the industrial census, and the quantitative surveyor do not normally shine. We welcome more refined procedures, but for now, the numbers in Tables 2 and 3 provide much more detailed information than exists elsewhere, certainly on Russia and probably on most countries.

In the next Section, we examine the results of Tables 2 and 3 in context. The Russian transactional environment is in flux, somewhere en route from hierarchical central planning to the market. There are echoes of this path's starting point in the current decisions of firms. Moreover, the present transactional environment contains many features that are specific to the transition and to Russia. Thus we provide pertinent information both past and present. We also introduce additional details from our data set, from in-depth enterprise case studies, and from related research on the *arbitrazh* courts, in order to explain and to amplify the picture provided by the Tables.²⁴

The Russian Picture

During the Soviet period, the principal dynamic was vertical. Fulfillment of the national economic plan was the overriding goal for enterprises. Ministries provided enterprises with contracts consistent with plan goals. These so-called contracts bore only a superficial resemblance to contracts in a market-driven system, given that enterprises had almost no control over the identity of trading partners or the terms of trade. Breaches could be appealed to an administrative agency, known as state *arbitrazh* (or *gosarbitrazh*), but the arbiters' central concern was with plan fulfillment, rather than with legal niceties (Pomorski, 1977). When appealing to *gosarbitrazh*, enterprises were usually more interested in signaling the cause of production problems than in obtaining damages or other relief (Kroll, 1987).

Given the shortages prevailing in Soviet times, enterprises often had difficulty obtaining key planned inputs. Appeals to ministerial superiors were helpful in resolving these problems. Ministry decisions about which enterprises to help were inevitably colored by the importance of the output and the relationship with the enterprise. Thus, it was critical for enterprise

²⁴ Related case studies and analyses of the courts appear in Hendley (1998a,b,c).

management to maintain a good relationship with ministries, both the industrial ministry and the procurement ministry. (See generally Berliner, 1957.) Relationships with Communist Party officials were also important because these officials could pressure the contractual partner (or sometimes the ministry). Helping enterprises was often in the officials' self-interest (Granick, 1961, pp. 165-77), since evaluation and remuneration were inextricably linked to economic performance. Thus, in the Soviet era, governmental and third-party relationships were especially important.

Although the formal structure of the Soviet system emphasized vertical links, the pressure to fulfill the plan routinely forced enterprise management to seek inputs through informal horizontal channels. Behind the scenes, enterprises worked with so-called "pushers" (*tolkachi*) who specialized in offering incentives to contractual partners for contract fulfillment and in finding deficit goods from other sources (Berliner, 1988, pp. 34-36, 76-78). These transactions were illegal under Soviet law, but meeting the plan justified skirting the law. Few enterprises could have survived without some participation in the second economy. (See Grossman, 1977.) Thus, Russian enterprises were familiar with horizontal relational transacting before the 1990s.

In the late 1980s and early 1990s, the old system declined in fits and starts. The legalization of trading in goods for profit -- the Soviet crime of "speculation" -- saw the *tolkachi* and the second economy emerge from the shadows. Reforms hastened the decline of the administrative command system, while bureaucratic resistance slowed the process. With profit replacing plan as the key motivating force for enterprises, the ministries gradually lost their *raison d'être*. By 1992, the flagship Soviet ministries in charge of planning, prices, and supplies had been eliminated, and the industrial ministries had been largely decimated.²⁵ But the overall size of the Russian state bureaucracy has not declined and the Soviet era imparts a powerful legacy, suggesting that it is important to look for vestiges of the old system of administrative contract enforcement. At the same time, old relationships might persist in a different setting. For

²⁵ In some industrial sectors, ministries continued to exert power through their control over licensing and regulatory functions. (E.g., Hendley, 1998c, pp. 99-100) Some other ministries reconstituted themselves as "kontserny" and served as middlemen. (Kroll, 1991) Their ability to perform this function lasted only so long as their information about, and connections with, potential suppliers was superior to that of the enterprises themselves.

example, our survey reveals that 88% of sales directors believe that contacts with former officials of the old Soviet supply organizations have facilitated customer relations.

The reforms and the vast structural economic changes mean that enterprises face a massive shift in the transactional problems they face. During Soviet times, suppliers were more likely to default. The ubiquitous shortages of the Soviet economy left customers constantly fearful of late deliveries, though the tight ministerial control over the substance of contracts severely limited the ability of parties to protect themselves through careful drafting. Now goods are abundant, but a large proportion of enterprises lack liquidity and it is extremely difficult for suppliers to know which customers can pay. Thus, the increased contractual freedom, so desired by the old Soviet enterprises, has led to a variety of new challenges, which could have hardly been anticipated. In the following, we examine the popularity and effectiveness of the various strategies that enterprises are adopting in the face of these problems.

Relational Contracting. Relationships have always been important to the smooth functioning of the Russian economy. This basic truth is, of course, not unique to Russia. Almost everywhere, personal trust between trading partners inevitably affects how they deal with one another in routine transactions and what they do when problems arise. Tables 2 and 3 provide data consistent with that picture. The most frequently used methods of solving problems, and the most effective ones, are those that rely solely on enterprise-to-enterprise interactions. Foremost are formal meetings between lower level officials. Such meetings allow trading partners to resolve potential problems in a non-confrontational and relatively cheap manner.

More than three-fourths (77%) of the surveyed enterprises have held formal business meetings between lower level officials in an effort to prevent or resolve problems with suppliers. Older enterprises are more likely to employ this tactic. Among enterprises formed after 1990, use drops to 71%. Larger enterprises use such meetings more frequently than smaller enterprises.

There remains the question of the source of the personal trust that is implicit in relational contracting. One potential source is a history of working together. However, long term relationships in Russia often began with shotgun marriages arranged and enforced by Soviet ministries. These arranged marriages are most likely to survive into an era of transactional freedom when the parties have developed a relationship of personal trust, though mutual

dependence may also play a role. Even though enterprises can now freely decide to whom to sell output and from whom to buy inputs, many have chosen to maintain old ties. Among the surveyed firms, about half (48%) of customers and suppliers dated from the Soviet period.

Formal links between the enterprises can also serve to cement trust.²⁶ In 11% of enterprises, suppliers are shareholders. In 16%, customers are shareholders. Similarly, there are representatives of suppliers on the boards of directors of 8% of enterprises, and representatives of customers on 12%. When there are such links, enterprises are more likely to use formal business meetings between lower level officials to resolve problems. For example, of the enterprises that have suppliers on their boards, 95% utilize such meetings.

Trust may arise more quickly when the relations between the officials of the two firms have a personal character. Such personal trust has become a valued commodity in post-Soviet Russia, where default on contractual payments is commonplace. Many managers believe that the limited resources of their trading partners tend to go toward paying debts to companies to whom a personal obligation is felt. Our survey indicates that there is a personal dimension to the relationships with contractual counterparts in 50% of transactions.²⁷ But the data do not suggest that such personal contacts lead to extensive use of informal meetings. Table 2 shows that formal contacts are much more important than informal ones taking place in a non-business setting.²⁸

Self-Enforcement. The autonomy that came to Russian enterprises after the fall of the administrative-command system gave rise to an increased need for self-enforcing agreements. Absent personal trust, enterprises sought mechanisms that would induce their counterparts to perform without outside enforcement (whether by state institutions or private groups or individuals).

²⁶ When we use the word trust without the adjectives personal or calculative, both types of trust are implied.

²⁷ Some parts of the survey data consist of reports on the details of specific transactions undertaken by the enterprises. In the following, we take these specific transactions as indicative of the enterprise's transactions as a whole.

²⁸ This suggests that the informal meetings referred to in Table 2 might be laden with symbolism to a greater degree than the use of the word "informal" implies. This point is supported by the observation later in the paper that the strategy of using informal meetings is associated with the strategy of using contacts with third-party enterprises.

When markets have imperfections and when information about alternative trading partners is limited, the desire to keep trading with a partner can provide incentive for performance. When problems loom, the threat of stopping trade reminds the partner of the costs of default. If the problems are not solved, carrying out the threat is the ultimate remedy. This is the tactic most commonly used for dealing with buyers who renege (Table 3), and it is regarded as the most effective method. In the chaotic Russian environment, where non-payment has become almost routine, the threat of stopping trade could even be consistent with maintaining relational contracting. For example, 77% of enterprises that have customers on their boards of directors use this strategy, in contrast to 66% of all enterprises. But, we can fairly assume that severing trade reflects a complete erosion of the trust that undergirds a relationship.

The threat of stopping trade is only one element in the armor of enterprises who seek to construct self-enforcing agreements. Enterprises can adopt contractual terms that make contract fulfillment more likely, or use other mechanisms. For example, echoing Williamson's (1985) hostage model, enterprises maintain possession of the customer's property in 8.6% of sales transactions; in 7.5% of procurement transactions, supplier's property is held. However, these percentages pale in comparison with those for prepayment and barter, two mechanisms whose use is consistent with the pursuit of a self-enforcing transactional strategy.

With most enterprises operating at far below capacity, goods are easily available, but many enterprises lack the liquid resources to pay for them. A significant proportion of enterprises are seriously in debt to tax authorities and suppliers, and have great difficulty collecting debts owed to them. (Over 75% of surveyed enterprises are in arrears to the tax authorities. Over 90% of enterprises have customers in arrears.) Many enterprises are technically insolvent, but most muddle through without resort to bankruptcy protection. Creditors seek payment from debtors' bank accounts. (See generally Hendley, Ickes, and Ryterman, 1998.) When the funds are insufficient, petitions are registered with the bank, and any money that comes into the account is automatically transferred to creditors, in the order mandated by legislation.²⁹ This institutional

²⁹ There are separate registers (or *kartoteki*) for private and governmental debt. The priority for payment is established by article 855 of the Russian Civil Code, as modified by a December 1997 decision of the Russian Constitutional Court. (*Vestnik Konstitutsionnogo Suda Rossuskoj Federatsii*, no. 1, pp. 23-31, 1998) In most instances, a court judgment is a prerequisite for placing a debt on the *kartoteka*.

framework has prompted debtor enterprises to avoid using liquid resources and to hide such resources.³⁰ The most common schemes are to have customers pay suppliers directly or to create affiliated companies and funnel money through their bank accounts. This system, combined with the general absence of credit rating agencies, makes it extraordinarily difficult for suppliers to assess whether potential customers are able to pay.³¹ In contrast, ability to supply goods is usually easy to check -- finished goods inventories and spare production capacity are easily monitored.

Prepayment is one solution to this fundamental informational asymmetry, in which the customer's ability to pay is much more difficult to ascertain than the supplier's ability to supply. Demands for prepayment are certainly widespread, as evidenced by the responses in the parts of our survey that focus on one specific sales transaction and one specific procurement transaction. (The focus on a specific transaction arises because some information is best collected from a specific agreement rather than from averages across all enterprise transactions.) Seventy-five percent of enterprises include a clause in their sales contract requiring some sort of prepayment. Forty-one percent of enterprises demanded full (100%) prepayment. The average prepayment commitment of customers is 54% and the amount actually paid is 48%. Seventy-four percent of contracts for material supplies require some prepayment, with 45% of such contracts requiring full prepayment. For procurement, the average contractual commitment is 58%, with actual payments amounting to 50% of the total price.

Interviews conducted during case studies suggest that the level of personal trust is inversely correlated with the amount of prepayment. Enterprise managers consistently stressed that they are less likely to insist on prepayment from long-term partners who have a track record of paying on time. Thus, first-time customers paid 60% of the purchase price in advance, whereas other

³⁰ Payments are further complicated by the perpetuation of the dual money system created during the Soviet period. Most payments are made using "noncash" (*beznaichnye*) money, i.e. through bank accounts. Interviews reveal that some enterprises have resorted to paying their bills in person with "cash" (*naichnye*) money. But doing so raises obvious personal safety and logistical issues.

³¹ Enterprises used a credit rating agency to investigate the ability of customers to pay in only 4% of transactions. Fafchamps (1996a, pp. 427-28) stresses the absence of a "mechanism by which information about bad payers is widely shared among firms" as a key cause for the problems in contract enforcement in Ghana.

customers paid 44% of the total price.³² Similarly, other mechanisms of self-enforcement serve as substitutes for prepayment. Advance payments average 36% when the supplier holds some of the customer's property, but 49% otherwise. Market power is also a substitute: an enterprise is less likely to breach when it has few alternatives and knows that it will have to return to the same contractual partner at a future time (Kranton 1996). Thus, customers pay dominant suppliers 44% in prepayment, while non-dominant suppliers are pre-paid 53%.³³

Of course, self-enforcement of transactions in goods is not the only reason for prepayment. Lack of available credit has left some enterprises unable to finance the costs of production. This is particularly a problem for those enterprises with a long production cycle and/or those who manufacture big-ticket custom-made equipment. Of the surveyed enterprises, 68% received advance payment sufficient to cover the cost of the material inputs needed for production.

Barter is another mechanism that has elements of self-enforcement, but which has many other causes. Barter can help self-enforcement in several ways. Barter removes some of the difficulties of checking on the partner's financial circumstances: the ability to pay depends more on production capacity and inventories, which can be easily monitored. When two enterprises supply each other's production needs, the mutual ability to hold-up the other enterprise can create an incentive to perform. Perhaps most important in the Russian environment, a seller might be more secure in the arrival of a barter payment than a cash payment, since indebted enterprises are always likely to have their cash taken by creditors, including the tax authorities. It is less likely that a creditor will seize a barter payment.

The desire for self-enforcing agreements is only part of the explanation for the current prevalence of barter, and its dramatic increase over the past six years.³⁴ Barter transactions can

³² Review of sales department records in several enterprises in early 1998 shows that first-time customers are often asked to provide various sorts of certificates of good standing from bank, tax authorities, and corporate registry offices. These documents, while helpful, did not entirely calm the fears of sales managers, who still preferred prepayment from untried customers. Their ability to demand and obtain prepayment was also affected by the market power of the potential customer.

³³ Dominance is defined as more than 65% of the market, as in the Russian anti-monopoly law (Art. 4, "O vnesnenii," 1995).

³⁴ In 1992, an average of 10% of the sales of surveyed enterprises took place via barter, whereas by 1996, this figure had risen to 39%. Likewise, the average percentage of material supplies that were obtained by barter in 1992 was 10.5, compared to 42% in 1996.

take many different forms depending on the circumstances. Sometimes they are bilateral; in other cases they involve an entire chain (*tsepochka*) of enterprises. In this latter case, barter transactions might fall into the category of third party enforcement: there are many examples of barter chains where intermediaries (including former Soviet officials) have constructed chains of mutual dependence among enterprises.³⁵

Third-Party Enforcement. Other enterprises are the critical third party players in Russian contract enforcement. Table 3 shows that almost half of all enterprises use the possibility of damaging a customer's reputation with other enterprises as a way of reacting to non-performance. More generally, 90% of sales directors surveyed reported that their contacts with non-customer enterprises have been helpful in customer relations. When researching the ability of their customers to pay, 22% of enterprises sought information from other enterprises, more than for any other source. Those enterprises that sought such information were more likely to use the enforcement strategy of telling other enterprises about non-performance.

Table 2 indicates that 15% of procurement directors have sought the assistance of other enterprises when problems arise with their suppliers. The relative standing of the "other enterprises" option is the same in both tables -- this is the most used option apart from direct enterprise-to-enterprise contacts and litigation (or its shadow.) The differences between the frequency of use of the other enterprise option between the sales (48%) and procurement (15%) sides is not surprising. Defaults are more common in sales than in procurement transactions.

The use of informal enterprise networks for enforcement has only a weak formal counterpart. The data in Tables 2 and 3 show the peripheral role of business associations and financial industrial groups (FIG) in contractual enforcement. Despite the fact that 28% of the surveyed enterprises belong to some sort of business association or FIG, only a small proportion of enterprises call upon these associations for help in solving transactional problems.³⁶ In

³⁵ Since high debt levels often limit enterprises' access to their bank accounts, making it impossible for them to pay for goods directly, they can only obtain inputs with the help of third-party intermediaries.

³⁶ Germany and Great Britain, in which industry and trade associations have been institutionalized, provide interesting contrasts to Russia. See Lane and Bachmann, 1997, pp. 234-43.

addition, only 3.5% of enterprises used associations or FIGs to check up on the ability to pay of prospective customers.³⁷

Table 2 confirms the unimportance of political parties or movements in post-Soviet inter-enterprise relations despite the heritage of Communist Party officials as the universal fixers of the Soviet economy (Granick, 1961). Only one of our 328 surveyed enterprises had sought help from a political party to prevent or solve its problems with suppliers, reflecting the disintegration of the old Communist Party structure and the changed role of the new political parties.

Private Enforcement. Two basic strategies for private enforcement exist in Russia, as in most countries. The first, dispute resolution through private arbitration, is benign. The second, enforcement by private agents often through intimidation, is more ominous, both for the parties and for society more generally. Our data indicate that neither is an important strategy for Russian enterprises.

Private arbitration tribunals, known as *treteiskie* courts, have always existed in Russia (Vinogradova, 1997; Pistor, 1996; Halverson, 1996). During the Soviet period, their use was restricted mostly to transactions involving foreign companies. Even this use was limited, since foreigners preferred Stockholm to Moscow. Disputes between Soviet enterprises that could not be resolved through negotiation or otherwise were generally submitted to *gosarbitrazh*.

During the past few years, new *treteiskie* courts have begun to sprout up across Russia.³⁸ Russian law places no restriction on their use. (See Hendrix, 1997; O'Donnell and Ratnikov, 1997.) Any enterprises can agree that disputes will be decided by a particular *treteiskii* court and in the presence of such an agreement, the *arbitrazh* courts will usually decline to hear the case, respecting the bargain of the parties to cede jurisdiction to the *treteiskii* court.³⁹ (Arts. 23, 85-3.107, 1995 APK) Notwithstanding the elimination of the institutional barriers to the use of *treteiskii* courts and the increased ease of access, the data in Table 2 indicate that few enterprises

³⁷ Our data suggest that the importance attributed to FIGs by some commentators is overstated. E.g., Eckstein et al., 1998, pp. 87-92.

³⁸ The creation of such courts is often funded by Western sources, based on the assumptions that the *arbitrazh* courts are hopeless and that instituting alternative dispute resolution mechanisms is the best response to this problem.

³⁹ Absent such a clause, the *arbitrazh* courts exercise jurisdiction. Of course, if all the parties agree, any dispute can be submitted to a *treteiskie* court or to international commercial arbitration.

are using them.⁴⁰ Those enterprises that have used the *treteiskie* courts have found them effective, thus suggesting that their judgments have been respected.⁴¹ A full analysis of the reasons why Russian enterprises shy away from the *treteiskie* courts is beyond the scope of this paper, but interviews with enterprise lawyers suggest that the cost and the unfamiliarity of procedural rules more than outweigh the speed and confidentiality that come with private arbitration.

When the issue of private enforcement of contracts in Russia is raised, few think first of *treteiskie* courts. The more common image is of enforcement by the nefarious Russian mafia, i.e., by non-state agents through coercion.⁴² A common wisdom has emerged in the media and even among scholars, that Russian enterprises routinely rely on private enforcement and, absent such services, would not be able to stay in business. For example, Leitzel et al. (1995, pp. 28-29) argued that, "...perhaps [the mafia's] main benefit is contract enforcement....Unsavory as the mafia's enforcement tactics are, they give Russian business people the confidence to enter into contracts that would otherwise be too risky." (See also Shelley, 1995, p. 830; DiPaola, 1996, pp. 158-64; Hay, Shleifer, and Vishny, 1996; Varese, 1997, p. 580) This is grounded in the assumption that the *arbitrazh* courts are unworkable (Shlapentokh, 1997, p. 875; Black and Kraakman, 1996, p. 1926). However, our survey data indicate that the assumed futility of appealing to the courts is much overstated, given the responses when we asked general directors to compare the courts and private enforcement along key criteria. The directors rated private enforcement superior only on one criterion, speed. They considered the courts better on

⁴⁰ Halverson (1996, p. 92) notes that "in spite of the many domestic arbitration tribunals that have been established in Russia during recent years, these tribunals are seldom utilized by Russian businessmen." According to Hendrix (1997, p. 1080), about 500 cases are filed each year with the International Commercial Arbitration Court in Moscow, the busiest of the *treteiskie sudy*. The caseload has remained at this level since 1992. By contrast, the *arbitrazh* courts decided more than 340,000 cases in 1997, more than 11% of which were heard in Moscow. (See Sudebno-arbitrazhnaya statistika, 1998)

⁴¹ As with other private tribunals, enterprises must pay to use these *treteiskie* courts. The amount is substantially greater than the filing fees required by the *arbitrazh* courts. (See Hendrix, 1997, p. 1081) Enterprises are unlikely to go forward with a case in these *treteiskie* courts unless sure that the other side will comply. *Treteiskii* court judgements can be enforced by *arbitrazh* courts, but this is not a desirable outcome.

⁴² We offer no definition of the term mafia. We use the term in the manner it is commonly used, a colloquial, hopelessly imprecise reference to all manner of semi-legal and illegal groups.

competence, cost, certainty of enforcement, and confidentiality. This evidence hardly suggests that enterprises are turning to the mafia out of frustration with the *arbitrazh* courts.⁴³

Our data suggest only a very limited use of private enforcers to encourage contractual compliance. As Table 2 shows, less than 3% of enterprises had used private firms to prevent or resolve problems with suppliers.⁴⁴ Further buttressing this interpretation is the fact that only 2.5% of enterprises use private security firms to investigate customer's ability to pay. If contract enforcement were really the domain of such firms, then it would be unlikely that they would have such small a role in providing information on the probability of contract fulfillment.

To be sure, there are powerful criminal groups in Russia and enterprises are concerned with security. Half of the surveyed firms either have an internal security service that assists in collecting debts and delivering output or have hired an outside security firm to perform these services.⁴⁵ These results suggest that security services have the more prosaic mandate of protecting money or property, rather than the task of enforcing contracts through intimidation of trading partners.

Administrative Levers of the State. As noted above, contract enforcement during the Soviet period was intimately tied to the planning and supply systems. Enterprises could expect help from ministries and other state agencies in obtaining the resources necessary to meet the plan. Soft budgets guaranteed continued existence, since the state would routinely bail out enterprises experiencing financial difficulties. This institutional heritage was common to the vast majority of the surveyed enterprises, since 88% were state-owned at some point. These enterprises are

⁴³ In the pilot study of this survey (Hendley et al., 1997), some enterprises reported that sometimes the mafia simply implemented the judgments of the *arbitrazh* courts.

⁴⁴ On the assumption that the mafia specializes in debt collection, it is tempting to conclude that this result reflects our inclusion of this question in Table 2, which focuses on supplier problems, rather than in Table 3, which focuses on customer problems. But even if the assumption is correct, the conclusion is not. More than half of the contracts studied involve prepayment, so that supplier non-performance is the most likely cause of a breach.

⁴⁵ More specifically, 24% of enterprises use internal security services (11% on a daily basis), and 38% use outside security firms (8% on a daily basis). Some, of course, use both.

now generally privatized and the state's ownership stake has been eliminated in most of them.⁴⁶ The mutually re-enforcing system of plan dictates and soft budgets has vanished.

The tendency to turn to the state had become deeply ingrained over the decades of Soviet power. Enterprises remain in fairly close contact with the state: in 66% of enterprises, senior enterprise officials meet with local or oblast government officials at least once a month and in 27% of enterprises meetings occur this frequently with federal officials. Regular meetings between firms and governmental officials do not necessarily indicate a continuation of the old patterns, however. The Russian government, like governments in all market economies, exerts considerable regulatory power. The key issue in this paper is whether these meetings deal with matters of contract enforcement.

The results of Tables 2 and 3 indicate that few enterprises look to the state for help in solving problems with customers and suppliers. Not surprisingly, petitions to the local or oblast government are more frequent than to the federal government. Such contacts are easier to organize and more likely to be grounded in a personal relationship. What is particularly revealing is that the enterprises who have used this strategy rate its effectiveness (column 3) very low compared to all the other options included in the Tables. Similarly, while general directors of 16% of the surveyed enterprises reported that the local or oblast government had attempted to solve problems with suppliers or customers, on balance, they viewed such mediation as detrimental.

The simplest explanation of these results is that some actors continue old patterns of behavior in new circumstances where the behavior is much less effective. Thus, older enterprises are more likely to adopt a strategy of seeking state intervention in solving problems with trading partners.⁴⁷ Enterprises' use of this strategy is strongly correlated with their receipt of direct subsidies from the state, but only 8.5% of enterprises receive such subsidies.⁴⁸ The strategy of seeking the state's help with transactional problems is unrelated to the level of present state

⁴⁶ Seventy-seven percent of enterprises surveyed have been privatized. Local and oblast-level governments own shares in 10% of the enterprises; the federal government owns shares in 13%.

⁴⁷ Of firms formed in 1990 or before, 11% have used this strategy, but only 6% of firms founded after 1990 have used it.

⁴⁸ Of enterprises receiving direct state subsidies, 21% use this strategy. Only 9% of those not receiving subsidies use it.

ownership, but strongly correlated with prior state ownership. Of the enterprises that were previously state owned, 11% used this strategy, whereas only 5% of enterprises that were never owned by the state did so. These results suggest that the state's tightening fiscal constraints are more important than privatization in changing the long-established patterns of behavior.

The transition to the market has witnessed the introduction of a significant number of new institutions, including bankruptcy commissions, the securities commission, and anti-monopoly committees (AMC). The AMCs are potentially important at the level of enterprise transactions, because, in theory, their task is to stamp out any anti-competitive behavior, for example, by punishing a dominant enterprise that uses its market power to force a trading partner to accept a contractual breach. (See Sahlas and Reshetnikova, 1997.) If an enterprise is subject to such behavior on the part of a trading partner, it can appeal to the local AMC for relief. Although this structure has been in place since 1991, it remains peripheral in transactional issues. Only about 10% of the surveyed enterprises had turned to the AMCs for assistance on any matter during the two years preceding our survey.⁴⁹ And as Table 3 reveals, enterprises view the AMC's as ineffective in matters connected to transactions. These data and interviews with enterprise officials suggest that enterprises are not actively mobilizing the new market-oriented state institutions on their behalf. In general, appeals to the AMC seem to be connected to an administration-oriented strategy: there is a high correlation between the use of strategies appealing to local or national government and appeals to the AMCs.

Shadow of the Law. There are strategies that raise the specter of litigation, often through the threat of filing suit or of pursuing punitive remedies. In Russia, as elsewhere, such warnings often spur greater interest in negotiated settlements. Prior to 1995, enterprises had to send letters ("*pretenzia*") demanding performance from defaulting trading partners before filing a lawsuit.⁵⁰ *Pretenzia* remain in widespread use, despite the fact that they are no longer a pre-condition to a lawsuit. Table 2 indicates that well over half of the enterprises use *pretenzia* as a method of dealing with problem customers, and that this tactic is seen as relatively effective. Surveyed

⁴⁹ An additional 10% of enterprises had been the target of an AMC investigation during the past two years.

⁵⁰ Failure to send a *pretenzia* was automatic grounds for dismissal of the claim. (Arts. 79, 80, and 86, 1992 APK)

enterprises report on average that they send a warning letter to 38% of delinquent customers. Enterprises with legal departments are much more likely to send *pretenzia*. While 71% of such enterprises resorted to *pretenzia* at one time or another, only 50% of those without a legal department ever sent them. Thus, even though *pretenzia* are not formal legal documents, many firms view their preparation as primarily within the purview of lawyers.

The continued use of *pretenzia* might be the result of routinized behavior that persists even though no longer mandatory. But sending these letters was never an empty gesture: it was part of the effort to pressure a recalcitrant counterpart. *Pretenzia*, which typically include a threat of litigation, ratchet up the pressure from phone calls or letters merely reminding the counterpart of passed deadlines. Our data on the results of one specific procurement transaction per enterprise bear out this common sense interpretation. In these transactions, 24% of enterprises reported receiving an informal or verbal complaint about their performance. *Pretenzia* were received by 8% of enterprises. Penalties were assessed against 5%, and paid by 3%. Litigation commenced with respect to 1%. This implies that the vast majority of problems are resolved through informal reminders, without even having to send *pretenzia*, and that most of the remaining disputes are resolved prior to initiating lawsuits.⁵¹

As this indicates, penalties are an element of bargaining within the shadow of the law, rather than a mechanism of self-enforcement or of relational contracting. Enterprises that routinely include penalty clauses in their sales contracts emerge as more likely to send *pretenzia*.⁵² In contrast, when general directors believe that demands for penalties will damage the relationship with the customer, *pretenzia* are used less frequently.

Penalties for contractual non-performance are traditionally permitted in civil law countries, and Russia is no exception.⁵³ During the Soviet period, penalties were assessed mostly for late

⁵¹ These data suggest that for every 100 transactions, 24 experience potential disputes. Of these, 16 are resolved through informal complaints, 7 are resolved through threats of litigation and/or penalties, and 1 will be litigated.

⁵² Of the enterprises whose use of penalties in sales contracts is above the median level, 68% use *pretenzia*, whereas usage drops to 49% among enterprises below the median level.

⁵³ U.S. law allows parties to predetermine the damages that would result from a breach, but such liquidated damages must be reasonably related to actual losses. Penalties are not enforceable. See Restatement (Second) Contracts, Section 356(1); Section 2-718(1) of the Uniform Commercial Code; and Clarkson, Miller and Muris (1978).

delivery or sub-standard quality. The amounts were minimal, providing a signal to ministries rather than punishment to enterprises. As inter-enterprise arrears mounted in the early 1990s, penalties for late payment became routine.⁵⁴ The surveyed enterprises report that 53% of their sales contracts include a clause penalizing late payment. But inclusion of penalties in a contract does not imply that late payment immediately triggers demands for penalties. Although more than half of enterprises have threatened delinquent customers with a demand for penalties in the two years prior to the survey (see Table 3), sales directors report that penalties are actually collected in only 8% of cases where payment is overdue. These data, buttressed by interviews, imply that penalties are included mostly to provide negotiating room. The decision as to whether or not to seek penalties is affected by the nature of the relationship between the parties.

While collateral arrangements are commonly used in market economies as a means of enforcing contractual obligations without resorting to litigation, this practice has not yet emerged among Russian industrial enterprises. Only 4% of enterprise sales and procurement contracts incorporate a formal collateral arrangement. Interviews suggest that the cost of the mandatory notarization (1.5% of the value of the transaction) discourages many enterprises from using collateral as security. The use of informal collateral, the possession of the other party's property discussed above, is more common than the use of formal collateral.

Litigation. Going to court is rarely the preferred method of resolving disputes. Russia is no exception. In Russia, as elsewhere, only a small fraction of disputes between trading partners ever end up in court.

Russia has a dual court system. The *arbitrazh* courts, which came into existence in 1991 as an institutional successor to *gosarbitrazh*, exercise jurisdiction over business disputes involving legal entities. (Art. 22, 1995 APK, Iakovlev and Iukov, 1996, pp. 43-63) Courts of general jurisdiction hear all other legal matters. As market reforms have progressed, the disputes submitted to the *arbitrazh* court have grown more and more complicated. Not surprisingly, cases now take longer to process. The increased use of penalties means that the amounts being

⁵⁴ A 1992 presidential decree authorized industrial enterprises to charge penalties of up to 0.5% of the amount owed per day for their sales and procurement contracts (Postanovlenie, 1992). Article 395 of the Civil Code also allows for penalties calculated on the basis of the Central Bank's annual discount rate. A 1997 plenum of the Higher *Arbitrazh* Court attempted to clarify what sorts of penalties can be awarded by the courts. See Postanovlenie, 1996.

demanded are no longer symbolic. The *arbitrazh* courts have struggled to come up with mechanisms for ensuring compliance by the losers. (See Hendley, 1998b) It is hardly surprising, therefore, that the surveyed enterprise lawyers expressed nostalgia for the halcyon days of *gosarbitrazh*. They believe that *gosarbitrazh* was quicker and cheaper to use, and that decisions were better implemented. They are right, but this is surely a consequence of the greater complexity of dispute settlement in a market economy.

An odd consensus has emerged among commentators that the *arbitrazh* courts are not up to the task before them and irrelevant to the needs of the economy. These courts, according to this consensus, are compromised by the judges' lack of competence in market economics, the persistence of outside influence (the "telephone law" familiar from the Soviet period), and the difficulty of enforcing judgments. As a result, enterprises are shunning the courts in favor of private enforcement. (See, for example, Halverson, 1996, pp. 100-103; O'Donnell and Ratnikov, 1996, pp. 838-41; Black and Kraakman, 1996; Hay, Shleifer, and Vishny, 1996 pp. 560-62.) Our data refute key elements of this common wisdom. Enterprises were asked to rate the importance of eight potential obstacles (enforcement, cost, competence, etc.) to submitting their disputes to the *arbitrazh* courts. The lack of enforcement was rated as the most important problem, whereas the judges' lack of knowledge was rated as relatively unimportant. Moreover, as we have made clear above, enterprises rate the courts as superior to private security firms on most criteria.

Enterprises clearly regard the courts as a viable option when negotiated settlements prove elusive. For example, during 1996, 40% of the surveyed enterprises had initiated 6 or more lawsuits; and 28% had been sued 6 or more times by other enterprises.⁵⁵ Tables 2 and 3 show that 61% of enterprises have filed claims, or threatened to file claims, against delinquent customers at some time in the two years prior to the survey, and 25% of enterprises have done so against suppliers. Moreover, as those Tables demonstrate, enterprises give the courts a relatively high ranking in terms of effectiveness. It is clear that, apart from direct enterprise-to-enterprise contacts, threatened or actual use of the courts is the most important method of contract enforcement in Russia.

⁵⁵ Significant numbers of enterprises had not used the *arbitrazh* courts at all during 1996. Twenty-eight percent had no cases as a plaintiff, and 42% had no cases as defendant. For a more detailed breakdown of litigation patterns, see Hendley, Murrell, and Ryterman, 1998.

In the view of Russian lawyers, the inability to enforce judgments is the single biggest shortcoming of the *arbitrazh* courts. The chairman of the Higher *Arbitrazh* Court, which stands at the apex of the *arbitrazh* court system, has acknowledged that implementation is the Achilles' heel of the system (Vasil'eva, 1996; see also Hendrix, 1997, pp. 1098-1100; Hendley, 1998a). Yet when asked whether improving the enforceability of *arbitrazh* court decisions would help in developing transactions with new suppliers, general directors felt this would have little impact. Thus, despite the perennial complaints about enforcement, enterprises do not believe that reforms in this area would make much difference.

Enterprises with legal departments do go to court more frequently than other enterprises. Comparing enterprises with legal departments and without, 77% of the former group have gone to *arbitrazh* court, in contrast to 51% of the latter group. As with *pretenzia*, this indicates that firms regard litigation as the responsibility of lawyers. These results may seem natural to Western observers, but are intriguing in the Russian context, since legal representation is neither required nor routinely observed in *arbitrazh* cases. (See Hendley, Murrell, and Ryterman, 1998.)

Complementarities Between Strategies

An interesting question arising from Tables 2 and 3 is whether the propensity to use any one strategy is related to the propensity to use any other. Examining this question gives insights into important issues in the nature of transactional strategies and the development of Russian institutions. For example: is relational contracting inconsistent with law-related approaches (Macaulay, 1963, Williamson, 1985)? Do vestiges of the old Soviet system appear in the market enforcement mechanisms? Is there a separation between those enterprises that use networks and those that use legal institutions (Kali, 1998)? Does government enforcement activity bolster market institutions? What are the differences between the roles of the federal and local governments in the transactions processes?

Of course, most strategies will be substitutes. For example, if an enterprise has the help of other enterprises in enforcing its contracts then the enterprise will have less need to go to court or to enlist private enforcement firms, other things equal. Thus, we will not focus on patterns of substitutes. Rather, the more interesting question is which strategies are complements: are increases in the use of strategy X associated with greater use of strategy Y, *ceteris paribus*?

We look for complementarities using simple correlation analysis, employing a transformation of the data summarized in Tables 2 and 3. Let N be the number of methods of dealing with problems in relationships that are listed in Tables 2 and 3.⁵⁶ Denote by S_{ij} the effectiveness score given by enterprise i to method j . (These are the scores summarized in the last columns of Tables 2 and 3.) Searching for complementarities using the S_{ij} would possibly give misleading results: it would be natural for S_{ij} to be positively correlated with S_{ik} simply because enterprises with many problems will likely use many methods of addressing these problems. Thus, use of the untransformed data, S_{ij} , does not reflect an adjustment for the basic *ceteris paribus* condition in the notion of complementarity; i.e., one should compare patterns of strategy use control adjusting for overall use of problem-solving strategies. This suggests that the data will reveal complementarities more incisively if we examine the relative use of strategies. Thus, we focus on:

$$s_{ij} = S_{ij} / \sum_{k=1}^N S_{ik}$$

We conclude that strategy j is complementary to strategy k if s_{ij} is significantly positively correlated with s_{ik} across enterprises, i .⁵⁷

Diagram 1 summarizes the results of this search for complementarities. Any two strategies that are complementary to each other appear together in an enclosed oval. If two strategies are not contained in the same oval, then they are not complements. The Diagram very closely represents the patterns of statistically significant correlation coefficients in our data, with some slight modifications to simplify its structure. There are 19 correlation coefficients in our data that are significantly greater than zero at a 5% level of significance. The Diagram identifies 22 pairs of complements: 19 that correspond to the statistically significant correlation coefficients, plus three more. (The three additional pairs are: informal meetings of enterprise personnel and informing other enterprises (positive and significant at the 10% level), informing other

⁵⁶ N equals 15 in this analysis. In Tables 2 and 3, there are 17 conceptually distinct methods listed. (Some methods are repeated in the two tables.) We exclude from the analysis the two methods (political parties and social, religious etc. organizations) that are used by fewer than 1% of the enterprises.

⁵⁷ We use 5% levels of significance in one-sided tests.

enterprises and reporting to a business association (positive and significant at the 10% level), and the intervention of banks and the use of *pretenzia* (indistinguishable from zero.) In imposing a slightly more simplified structure on the diagram than that derived from a purely mechanical exercise, we view that diagram as a theory suggested by the data.

Of course, given a sufficiently tangled web of geometric shapes, it would be possible to represent any set of complementarities in such a diagram. Thus, it is the simple structure that is crucial.⁵⁸ For example, although there are many complementarities between the various third party and governmental enforcement mechanisms, these complementarities appear as links between neighbors when these mechanisms are laid out in a linear fashion. The legal system complements only adjacent elements along this linear arrangement of third-parties.

What insights does the diagram offer?

1. The use of the various relational contracting strategies largely stands on its own, supporting the conclusion that these strategies do not naturally combine with others that look outside the bilateral relationship.
2. The joint complementarity of five mechanisms appearing in the lower part of the diagram is notable. Associations are often attempts to recreate defunct Soviet structures; older enterprises are more likely to rely on contacts with third-party enterprises; the federal government is the institutional successor of the only powerful element of the Soviet government; penalties are a traditional remedy for contractual non-performance dating back to the Soviet days (though the amount and impetus for seeking them has changed); and lastly the informal contacts outside the enterprise suggest long-standing traditional ties. Together, these points suggests that there is a group of enterprises that feels more comfortable with remnants of the old system when picking its profile of transactional strategies.
3. Some enterprises prefer to rely on the state, with the anti-monopoly committees appearing to have a role that reflects their position as an arm of government, rather than their mandate as a facilitator of competition.
4. Some enterprises combine the use of institutions that have effectively been reinvented in the post-Soviet era. Banks, courts, and local government, which appear together in the diagram,

⁵⁸ None of the conclusions that we draw is dependent upon the simplifications referred to in the previous paragraph.

represent institutions whose status and independence has risen dramatically in the 1990s.⁵⁹ Thus, these complementarities suggest that some enterprises are breaking with the past in their transactional strategies. This approach is much more in tune with the institutional arrangements of a market economy than those used by the enterprises associated with approaches 2 and 3 above.

5. Finally, private enforcement firms and the *treteiskie* courts seem to be complements, but so few enterprises use these alternatives that we would attribute little significance to this observation.

Perhaps the most fascinating feature of the diagram is the insight that it gives into the impetuses behind institutional development in modern Russia.⁶⁰ The federal government is associated with an approach to transactional strategies that emphasizes the vestiges of the Soviet system. Appeals to the local government are complementary with the use of institutions that are central to a market economy. The development of institutions designed to facilitate market transactions may have been adversely affected by the ongoing center-periphery political struggle. Legal reforms centered on the federal government might have fallen afoul of the connections between it and the remaining legacies of the Soviet system. A failure to fully embrace the forces for change at the local level may have lessened the effectiveness of institutions that are important in aiding the efficiency and predictability of business relations.

Conclusions

This article represents a first attempt to fill in the gaps in our knowledge about how Russian enterprises do business. We have focused on the strategies pursued in efforts to prevent or solve problems with trading partners. Our analysis shows a strong propensity for working out problems without resorting to outsiders (whether private or governmental). In the chaotic world of the transition, strategies that use trust -- both personal and calculative -- emerge as critical. Interviews with managers confirm the importance of personal relationships or at least having an

⁵⁹ Independence and status are, of course, relative concepts. While the courts have undergone substantial reform over the past decade, few would regard them as truly independent or high status institutions. Yet progress in this direction has been made. See generally Solomon (1998).

⁶⁰ In making these comments, we assume that our six cities are representative of Russia as a whole.

opportunity for face-to-face meetings to judge integrity. Equally important is an assessment of the material interests of potential (or long term) partners. Whether the relatively important role of strategies using trust will wane as the Russian market develops remains to be seen. Certainly, the costs of evaluating the trustworthiness of potential counterparts should decrease over time, since many of these costs are associated with transitional phenomena, such as the presence of large numbers of indebted enterprises.

At first glance, our finding that many Russian enterprises have filed claims in the *arbitrazh* courts may seem to be in conflict with a propensity to work out problems through direct contacts. Yet, on-site interviews reveal that enterprises regard these two strategies as two parts of a larger whole. Rarely do they respond to non-performance by immediately filing a lawsuit. Instead, they try to work out problems, resorting to the *arbitrazh* courts only when negotiations break down. The decision as to when to abandon negotiations is affected by a myriad of considerations, including the length and depth of the underlying relationship and the relative market power of the two parties. (See generally Felstiner et al., 1980-81)

The idea of litigation as a last-ditch alternative -- but still an acceptable alternative -- may seem obvious to many readers. But to those who are familiar with the literature on Russian legal developments, this idea is somewhat surprising. Almost without exception, this literature contends that the *arbitrazh* courts are not being actively used, and that their pervasive flaws have doomed these courts to peripheral status.⁶¹ As our data show, this impression is simply wrong. Why commentators have been so willing to write off the *arbitrazh* courts is something of a mystery. Perhaps the usual carping of litigants about delays and perceived injustices were taken too literally, or perhaps Western observers have held the Russian courts to an unrealistically high standard. The reasons are not particularly important. While we are not arguing that the *arbitrazh* courts are anywhere near perfection, our data clearly document that they play a significant role in the Russian economy.⁶²

⁶¹ Not all commentators have completely dismissed the *arbitrazh* courts, e.g., Hendrix (1997), Pistor (1996), Halverson (1996).

⁶² In a previous study (Hendley et al. 1997), based on the pilot interviews for the enterprise survey whose data is reported here, we reached conclusions that could be interpreted as assigning a smaller role to law and legal institutions than we do in this paper. In that study, we focused, much more than in the present paper, on active strategies for restructuring relationships and less

Our analysis also sheds light on the role of the mafia in Russia. One common view of the rise of the mafia in Russia is that it is a functional response to the weakness of official contract enforcement mechanisms (Shleifer, 1994, p. 103; Leitzel et al, 1995; DiPaola, 1996). An alternative view is that there is little redeeming social value to the mafia; it is strong because the state is weak in controlling crime and because the institutional environment engenders criminal activity through corruption (Handelman, 1995). Our data strongly suggest that the first view is greatly over-stated and that the rise of the mafia has little to do with the demand by Russian businesses for contract enforcement.

We began this paper by pointing to the paucity of detailed empirical information on the relative importance of the various strategies that businesses use to govern their transactions. This gap in empirical knowledge is as true for developed economies as it is for transition countries. Thus, we would like to think that the results appearing above have a significance that is wider than simply understanding the nature of present-day Russia. Of course, Russia has many special characteristics, making generalization to other countries hazardous. Indeed, it is now commonly assumed that the mix of transactional strategies pursued depends critically on deep underlying characteristics of the country in which the firms are located (Greif, 1996; Uzzi, 1996). This is of course a theory based on anecdotal observation, a theory that has not been tested systematically.⁶³ At the very least, we have provided a methodology that could be replicated for other countries and the results for Russia, which could form the basis for testing this theory.

on the role of the shadow of the law and the use of courts in resolving disputes in existing agreements. We nevertheless noted the relative esteem in which the courts were held, at least compared to other institutions, and the frequency with which enterprises were using courts.

⁶³ One exception is Sako's (1992) study, examining the relative roles of relationships and the law in the UK and Japan.

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Table 1: Seven Strategies That Enterprises Use in Pursuing Efficiency and Predictability in Business Relations

	Strategy	Russian examples	Enforcement methods	Reliance on outsiders	Personal trust in counterpart	Reliance on reputation	Use of law
1	Relational contracting	Meetings, especially between lower level officials	Personal pressure; fear of erosion of personal trust	Low	High	Medium -- personal trust dominates	None
2	Self-enforcement	Threats to stop trading; pre-payment, barter	Calculative trust based on future interactions; fear of erosion of reputation	Low	Low	High -- enterprises aim to accumulate reputational capital	Low
3	Third-party enforcement	Telling others, e.g. other enterprises	Shame; lost economic opportunities from group	High - not state	Varying - depending on nature of group	High -- especially third-party reputation	Low
4	Private enforcement	Private arbitration; "mafia" or security service	Judgment of impartial actor; threats and/or violence	High- not state	Low	Varies: low for reputation of transacting party; high for reputation of enforcer	Varies: extra-legal means might be used to enforce legal rules
5	Administrative levers of state	Asking a governmental organ for help	State munificence or harm	Significant - state	Medium	Medium	Medium
6	Shadow of law	Penalties; Pretenzia; ² Collateral	Threats to go to court; negotiated settlement	Significant - state	Medium	Medium	High
7	Legalistic	Arbitrazh court ³	Court order	High - state	Low	Low	High

Notes:

1. The dashed (-----) line between any two strategies indicates cases where the borderline is particularly fuzzy.
2. *Pretenzia* are letters requesting payment sent by the wronged party to their contractual partners before filing a complaint in the court. Prior to 1995, *pretenzia* were mandatory.
3. *Arbitrazh* courts hear business disputes between legal entities.

Box 1: The Question Posed to the Purchasing Department.

During the past two years, how important were the following methods in helping your enterprise to prevent and/or resolve problems arising in relationships with suppliers? First, please tell us whether you used the method. If the method was used, then please evaluate its effectiveness on a scale from 0 to 10. A '0' means either that the method was not used at all or that it was not effective and a '10' means that the method was very effective.

Method	1=Yes, it was used during the past two years. 2=No, it was not used during the past two years	On a scale from 0 to 10, how effective was the method during the past two years?
Formal business meetings between lower level officials of the trading partners.		
Formal business meetings between the general directors of the trading partners.		
Informal meetings between counterparts in the two enterprises, for example, in a restaurant, banya, recreational facility, or civic organization.		
Intervention by other enterprises.		
Intervention by officials of a business association or a financial-industrial group.		
Use of private enforcement firms (security firms, collection agencies, mafia, etc.)		
Intervention by banks.		
Intervention by representatives of political parties or movements.		
Intervention by officials of the local government.		
Intervention by officials of the federal government.		
Use of Arbitrazh courts.		
Use of treteiskie courts.		

Note: *Treteiskie* courts are private tribunals that arbitrate business disputes at the request of the parties.

Box 2: The Question Posed to the Sales Department.

Listed below are some possible methods of dealing with customers that did not honor their agreements with your enterprise. First, please tell us whether your enterprise has used or threatened to use this method during the past two years. Then, please tell us how effective either the threat of using these methods or their actual use has been in getting them to honor their agreements. Convey your views by choosing a point on a scale from 0 to 10. A '0' means either that the method was not used at all or that it was not effective and a '10' means that the method was very effective.

Method	Has your enterprise used or threatened to use this method during the past two years? 1=Yes 2=No	On a scale from 0 to 10, how effective is this method for getting other firms to honor their agreements with you?
Telling other enterprises about the behavior of an enterprise that did not honor its agreement.		
Forcing the enterprise to pay a financial penalty.		
Stopping trade with the enterprise.		
Filing a complaint against the enterprise with an antimonopoly committee.		
Sending pretenzia or other notices suggesting a possible court action.		
Filing a claim in arbitrazh court.		
Reporting the enterprise to a local government organ.		
Reporting the enterprise to a federal government organ.		
Reporting the enterprise to a business association or a financial-industrial group.		
Reporting the enterprise to social, religious, or civic organizations.		

Table 2: How the Purchasing Department Deals with Problems with Suppliers

(1)		(2)	(3)	(4)
Methods of preventing and/or resolving problems in relationships with suppliers. (The number in the left hand column identifies the strategy in Table 1 with which this method is associated)		Percentage of enterprises using method	Average scale score for those using method	Average scale score across all enterprises (assuming score = 0 if don't use)
1	Informal meetings between counterparts in the two enterprises, for example, in a restaurant, banya, recreational facility, or civic organization.	23.01	7.39	1.70
1,2	Formal business meetings between lower level officials of the trading partners.	76.38	7.51	5.73
1.2	Formal business meetings between the general directors of the trading partners.	56.44	8.52	4.81
3	Intervention by other enterprises.	15.34	5.34	0.82
3	Intervention by banks.	5.21	4.71	0.25
3	Intervention by representatives of political parties or movements.	0.31	3.00	0.01
3	Intervention by officials of a business association or a financial-industrial group.	3.99	4.85	0.19
4	Use of private enforcement firms (security firms, collection agencies, mafia, etc.)	2.76	6.22	0.17
4	Use of treteiskie courts.	1.84	4.33	0.08
5	Intervention by officials of the local government.	10.43	4.41	0.46
5	Intervention by officials of the federal government.	3.37	4.45	0.15
7	Use of Arbitrazh courts.	25.46	5.40	1.37

Table 3: How the Sales Department Deals with Customers that Did not Honor Agreements

(1)		(2)	(3)	(4)
Methods used or threatened in dealing with customers that did not honor their agreements. (The number in the left hand column identifies the strategy in Table 1 with which this method is associated)		Percentage of enterprises using or threatening method	Average scale score for those using or threatening method	Average scale score across all enterprises (assuming score = 0 if not used)
1,2	Stopping trade with the enterprise.	65.85	5.76	3.76
3	Reporting the enterprise to social, religious, or civic organizations.	0.91	2.33	0.02
3	Reporting the enterprise to a business association or a financial-industrial group.	2.74	3.00	0.08
3	Telling other enterprises about the behavior of an enterprise that did not honor its agreement.	47.56	4.41	2.08
5	Reporting the enterprise to a local government organ.	14.02	2.39	0.32
5	Filing a complaint against the enterprise with an antimonopoly committee.	7.32	2.91	0.20
5	Reporting the enterprise to a federal government organ.	7.93	3.46	0.27
6	Sending pretenzia or other notices suggesting a possible court action.	58.23	5.16	3.00
6	Forcing the enterprise to pay a financial penalty.	57.32	4.65	2.65
7	Filing a claim in arbitrazh court.	60.98	5.69	3.45

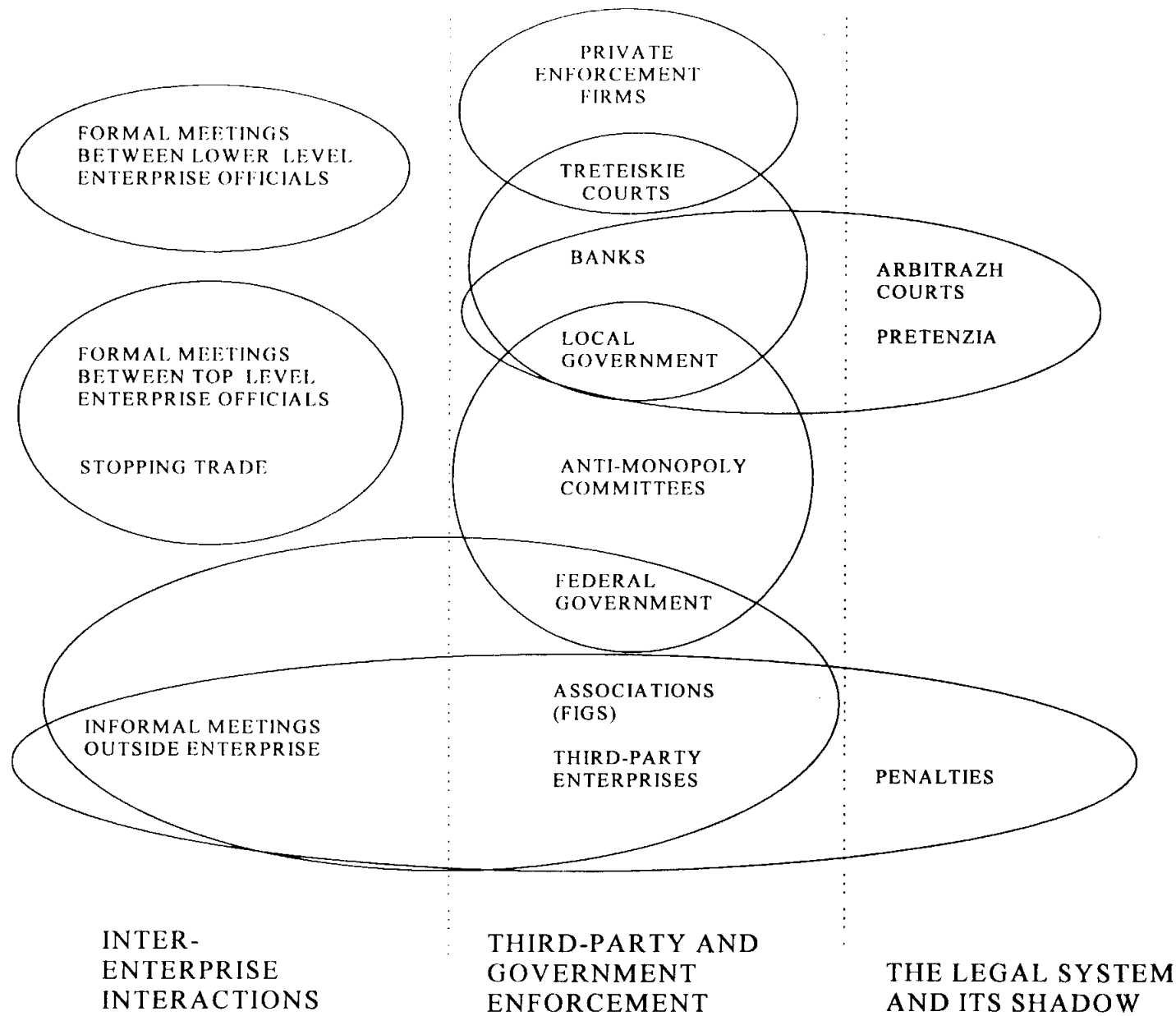


DIAGRAM 1: THE COMPLEMENTARITIES BETWEEN TRANSACTIONAL STRATEGIES