Legal Development in Post-Soviet Russia

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The Soviet legal system has proven ill-suited to the demands of capitalism, even in the nascent and arguably distorted form found in Russia today (Hendley, 1996; Rubin, 1994). Anecdotes abound of Western firms, having devoted significant resources to potential investment, pulling out in frustration over their inability to secure the most basic legal guarantees. Such frustrations have not been limited to international transactions; the absence of clear and enforceable rules has also stymied domestic Russian transactions (Hendley, 1995). The reality of post-Soviet Russia required new "rules of the game." Laws and legal institutions have had to be reoriented so as to facilitate market transactions rather than plan fulfillment.

A consensus quickly emerged as to how to reconstruct the Soviet legal system. Echoing the shock therapy debate, Russian policy makers and their Western advisors argued (the "Development Argument") that laws and legal institutions had to be reshaped in a rapid and necessarily top-down fashion. This was justified on the grounds that the resulting system would be better for all concerned over the long run.

A number of assumptions are embedded in the Development Argument. The first is the existence or emergence of a market, and of a state capable of enforcing the law when necessary. Second and more fundamental is an assumption that, if a Western-style legal system were put into place in post-Soviet Russia, then Russian economic actors would rely on these laws and institutions in their relations with one another. A demand for yet more law would be stimulated by mutually reinforcing desires for predictability in economic relations and for the protection of newly-found property interests. Finally, the concept of law embedded within the Development Argument is Western: law is viewed as a set of rules developed through cooperation between state and society that are applied across the board by institutions that are politically neutral, and are capable of being enforced, if necessary, by the state (Weber, 1967; Fuller, 1969).

Boycko and Shleifer (1995, p. 78) laid out one variant of the Development Argument:

A genuine demand for such [legal] reforms now exists, primarily because privatized and newly private firms need legal protection and commercial law to restructure. Critics of privatization, who argued that legal reform had to precede privatization, simply have missed the boat in their assessment of political capital. A year ago the political demand for legal reform did not exist. At this post-privatization point in the Russian economic reform process, however, legal reform is both essential and politically feasible.

Their focus is on privatization and the attendant reforms to the legal system. The same rationale, however, underlies a myriad of other legal reforms.

Virtually unchallenged, the Development Argument has become the basis for the reform of the Russian legal system. Getting the proper institutional pieces into place has become the goal. The use or non-use of the legal system is assumed to be primarily a function of the incentive structure. The simplicity of the Development Argument is appealing. But how does the logic of the argument play out in the contemporary Russian context? In this article, I argue that institutional changes have not prompted Russian economic actors to shift from a reliance on networks of personal relationships to a reliance on law. The increased efficiency that comes with

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2Boyko and Shleifer (1995, p. 78) contend that "[t]he weakness of the legal system has been ... the greatest complaint of foreign investors...." See also Halligan and Tepluhkin (1996, pp. 39–43); for specific examples, see Watson (1996, pp. 434–41) and Shokhin and Ryzhkov (1996).

3New rules were also needed to facilitate democracy. This article does not address such matters as electoral laws, delineations of power between national and regional authorities, and the like. Instead, its concern is exclusively with the use of law in market transactions.

4See Murrell (1993) for a description and critique of "shock therapy" as applied to the economy.

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5Notably, those engaged in Russian legal reform have apparently ignored the scholarly literature on failed efforts to build Western-style legal systems in the developing world in the 1960s; see Gardner (1980); Trubek and Galanter (1974).

6For example, this is the basic premise of many USAID-sponsored programs aimed at creating the rule of law in Russia; it also informs the recently approved $58 million World Bank loan to Russia for legal reform (World Bank, 1996). See also Aalund (1995, p. 247); Blasi (1995); Blasi and Shleifer (1996); Boyko, Shleifer, and Vishny (1995); Blumentfeld (1996).
the use of law, which seems so obvious to the proponents of the Development Argument, is less apparent to Russian economic actors. For Russians, shifting to a reliance on law requires not only departure from established patterns of behavior, but also relinquishing control and power over economic transactions.

Further complicating matters is the antipathy towards law shared by most Russians. The lack of autonomy of law, reflected in the capacity of the Communist Party to dictate the substance of the law and to reach into any legal dispute and dictate the result, contributed to a perception of law as an infinitely malleable tool of the Party. How law was applied depended very much on who was involved and his or her political connections. This highly particularistic legal culture was not conducive to the transition to the market (see Weber, 1967, p. 301).

A typical feature of market economies is an ability to engage in impersonal, arms-length transactions. Law, understood as being universally enforceable and relatively autonomous, facilitates such transactions, particularly when the contracting parties are strangers. Law provides a common set of assumptions for negotiation and a default mechanism for resolving disagreements. But Russian enterprise managers have had a different experience of law, which taught them that their personal connections (political and otherwise) could trump any apparent legal obligation. In contrast to their Western counterparts, Russian enterprise managers worried little about the enforceability of contracts or other legal formalities.

The incentives necessary to change behavior will come neither from the introduction of new laws and legal institutions nor from the improvement on paper of existing laws and legal institutions. Instead, change will come only when economic actors become convinced of the usefulness of law. During the Soviet past, law was seen as an instrument used by the state to achieve policy goals. Persistently absent from the Soviet concept of law was an understanding of law as a mechanism available to ordinary citizens to protect their interests from arbitrary actions by the state or other private actors. This state-centered view of law persists in post-Soviet Russia, though some have begun to question whether law is useful even to the state, given the state’s apparent inability to enforce its will on society.

THEORIES OF LEGAL DEVELOPMENT

While theoretical literature on the evolution of legal systems provides no definitive blueprint, the contributions of Max Weber and Douglass North are highly suggestive (Weber, 1967; North, 1990). Both are interested in what causes a legal system to develop in the direction of formal legal rationality: reliance on written laws and state-sponsored legal institutions to facilitate market transactions. Both take Western Europe as their primary example and seek to identify the dynamic force or constellation of forces that was critical in the development of such a system.

Weber’s legal sociology is remarkably rich, and has been further enriched by the work of later scholars (Unger, 1976; Nonet and Selznick, 1978). My intention is not to summarize this Weberian tradition, but rather to isolate those aspects that might be relevant to the present-day Russian experience. There are two threads of the Weberian cloth that deserve to be pulled out for closer examination. The first asks: what might entice economic actors unaccustomed to relying on law to do so? Weber and his followers take medieval Europe as their example. As traditional society became more complex and monarchs no longer enjoyed absolute power, groups such as the aristocracy and the burgeoning merchant class began to compete for political power. None were willing to cede to the others the power to determine the rules by which society would be governed. Over time, law emerged as a compromise—a solution that satisfied no one entirely, but that offered each group similar disadvantages. An analogous need for peaceful forums in which to resolve disputes explains the emergence of courts, first under the auspices of the merchants and later sponsored by the state (Weber, 1967, pp. 67–73, 145–46; Unger, 1976, pp. 66–78).

The rise of private property represents the second thread of the Weberian argument that is of interest. As it became possible and increasingly common for merchants to own property, they wanted to be able to protect themselves. Law constituted a mechanism for preserving their property interests, and gave them a method for alienating the property when needed. The combination of political differentiation and legalization of private property proved to be remarkably powerful in moving society in

7 Krzyger (1990, pp. 640–47) argues that this antipathy to law was common throughout the Soviet bloc. To some extent, such attitudes are present within all legal systems (Abel, 1990), but new widespread and pronounced as a result of the highly instrumental use of law by Soviet-style regimes (Hendley, 1996).

8 Autonomy of law is a relative concept: politics is never entirely absent (Fuller, 1969; Nonet and Selznick, 1978; Hendley, 1996). The question is not whether law is or is not autonomous, but whether autonomy has been articulated as a goal. For most of the Soviet period, autonomy of law in Russia was politically untenable.

9 The desire of contracting parties to preserve their relationship can be a powerful force for ensuring compliance (Macaulay, 1963; Macneil, 1985; Uzzi, 1996). Some scholars of East Asian legal systems argue that webs of relationships and informal norms have almost completely supplanted law as a means of governing commercial relations (Jones, 1994; Winn, 1994).

10 The distinction is largely in perceptions. Although American businessmen may rarely resort to the courts (Macaulay, 1963; Dunworth and Rogers, 1996; Kenworthy et al., 1996), they uniformly recognize that contracts are legally enforceable. Traditionally, Russian managers have not had to take contractual obligations seriously.

11 On the definition of formal legal rationality, see Bendix (1977, pp. 403–7); Krones (1983, pp. 73–75, 124–30); Trubek (1972).

12 Critical legal scholars argue that this vision of law as a neutral set of rules is naive. They contend that law inevitably reflects some set of interests, most often those of the politically and economically powerful (Mensch, 1982). There is some merit to this argument, but it does not diminish the power of the developmental dynamic identified by Weber.

In contrast to Weber, who sees political struggle as the germ of legal development, Douglass North focuses more on economic necessity. He traces the process by which law came to undergird commercial transactions. He sees the evolution of national and international rational-legal orders as a natural but not inevitable outgrowth of long-distance trade and the consequent expansion of production (North, 1990, pp. 120–21). Law serves as a means of lowering the transaction costs coincident to trade. More specifically, by regularizing agency relationships, law allows the businessman to send subordinates (not necessarily blood relatives) to handle the negotiations (p. 126). And by regularizing the rules governing contractual behavior, businessmen are no longer limited to trading with persons with whom they have developed a relationship of trust. Instead, with respect to both internal and external aspects of trade, businessmen can rely on the impersonal mechanisms and protections of law and legal institutions. Freedom from the limitation of personal knowledge of their trading partners opens vast new opportunities for trade and, of course, economic development.

Politics enters the equation out of necessity. According to North, the process of institutionalizing the rules of the game began in a bottom-up fashion. The standards for fulfillment and enforcement of contracts emerged out of custom and practice which, over time, took on regularity. The standardization came not from governmental edict, but as a result of the inherent logic and similarity of the solutions found to analogous problems. Thus, compliance stemmed from the legitimacy of the rules and the fact that businessmen had actively participated in their development, rather than from the coercive power of the state (North, 1990, 126–30; Milgrom, North, and Weingast, 1990). But as time went on, transactions became increasingly complicated, and businessmen no longer felt a vested interest in the integrity of the contractual regime, self-enforcement grew impractical and potentially dangerous. Only the power of the state could maintain the system. Impersonal rules became the subject of legislation to be interpreted and enforced by state-sponsored courts.

At the heart of the arguments of both Weber and North is an acceptance of the efficiency of law: that law tends to lower transaction costs (see Williamson, 1985; Coase, 1990). Weber is interested in the political efficiency of law. He contends that having default rules governing the formation and operation of relationships, and default forums for dispute resolution, is preferable to having to debate these issues at the start of every new relationship. Presumably North would not quarrel with such logic. His analysis, however, goes to the economic efficiency of law (North, 1990, p. 138). He argues that, while particularistic criteria such as trust and kinship may serve as the basis for economic transactions, their reach is limited. Universalistic criteria, such as positive law (both domestic and international) and state-sponsored courts, are necessary for complex business transactions and for sustained economic development.13

Moreover, the impetus for the creation of impersonal institutions and rules comes from the participants in the system. North is more explicit on this point than Weber, but the argument is implicit in the fact that Weber’s developmental trajectory involves a series of compromises. Such compromises cannot be dictated from above but necessarily evolve from below, at least in the first stages of development. The contention that participants will “demand” universalistic standards is predicated on the assumption that these participants recognize that law is the most efficient mechanism by which to organize their transactions.

A second set of assumptions that runs through both Weber and North relates to the role of the state. While both sketch out scenarios involving bottom-up legal development, they agree that this sort of widespread voluntarism occurs only in the first stages of development. Both assume that the state will have to step in eventually, and concur that law grows best in environments where the state is capable of imposing its will on society. The institutionalization of legal regimes in the form of statutory law and state-sponsored courts is taken to be a necessary step towards formal legal rationality (Weber, 1967, pp. 39–40, 162–67; North, 1990, pp. 129–30). Of course, the analysis is grounded in the experience of Western Europe, where the rise of law and capitalism paralleled the rise of the modern state.14

Neither Weber nor North asserts that formal legal rationality is inevitable. Both recognize that the Western legal tradition, with its reliance on formal laws and legal institutions, is the exception (North, 1990, pp. 98–100; Unger, 1976, p. 66). More common are societies where legal development gets “stuck,” and cannot make the leap to formal rationality. In seeking to explain the disparity, North focuses on the starting point of various societies, arguing that the institutional legacy will inevitably affect state capacity. In our opinion, path dependence cannot be ignored, but it robs the theory of much of its predictive power. An endless set of contingent factors exists that arrest the process of legal development. Often they become apparent only in hindsight.

In contrast to both Weber and North, globalization theorists see the impetus for change as lying outside the system (Shapiro, 1993). Technological advances that allow for instant communication and for rapid capital transfers create new demands (Breeden, 1993, p. 511). International actors (both multilateral financial institutions and private investment banks) strongly prefer standard rules. Indeed, some types of standardization are mandated by membership in international trade regimes (Hoekman and

13Other factors, including the banking system, the legal profession, and legal instruments such as letters of credit and negotiable instruments, influence the ability to engage in business transactions with strangers.

14Arguably, the role of the state is even more important in countries that develop later. Technological advances increased the cost of industrialization and other forms of development. Only the state was capable of forcing domestic savings and of attracting foreign capital (Gerschenkron, 1962, pp. 16–21; Chaudhry, 1995; Evans, 1995).
Kosteki, 1995). In other cases, pressure from stronger trading partners can influence domestic changes. Internal support for these reforms comes from economic actors (both private and governmental) who want to participate in international transactions. Globalization theorists share with North and Weber a belief in the fundamental efficiency of law, and in the need for a formally rational legal system in order to sustain a market economy.

FORMAL RATIONALITY AND POST-SOVIET RUSSIA

The appeal of this theoretical argument to adherents of the Development Argument is obvious. The goal of these Russian policy-makers and their Western advisors is to build a legal system that facilitates market transactions domestically, and that allows Russia to become an active participant in the global economy. These theories identify factors that may contribute to the creation of a developmental dynamic in the arena of law.

A case can be made that the starting conditions in Russia are auspicious, or at least conducive, to development toward formal legal rationality. Politically, Russia is emerging from a period of authoritarianism or neo-traditionalism (Jowitt, 1983) in which the Communist Party held a firm monopoly on political power. With the disintegration of the CPSU during the Gorbachev period, a wide range of alternative voices emerged with competing visions of the Russian future. None was capable of forcing all others to cede to its position, which gave rise to constant maneuvering for short-term gains. Political gridlock was the ultimate result. Under these circumstances, there is some hope that law might emerge as the common language of political discourse.

Economically, disintegration of the Soviet-era administrative-command system acted to liberate economic actors. In contrast to the past, neither the identity of trading partners nor the terms of the resulting agreements can be dictated from above. Economic actors are free to choose their counterparts, and to make any mutually beneficial agreement. Rather than looking to the economic ministries for approval, the market now imposes the ultimate sanctions. With this freedom came a new set of legal challenges. Much like the medieval merchants that North studied, Russian businessmen struggle with questions of agency and how best to protect themselves in transactions with new trading partners.

The past decade also witnessed the legalization of private property in Russia. The consequent privatization of state property included not only industrial enterprises, but also much of the housing stock. Although only

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18Shlapentokh (1996) lays out the negative implications for economic and political development of the parallel between post-Soviet Russia and medieval Europe. He contends (p. 395) that Russian political actors are "wholly absorbed with their private goals" and still tend to "avoid all compromises."

19The privatization of land is an exception (Sedik, Foster, and Liefert, 1996). Political battles continue to rage over the terms by which real property will be privatized.

20For a detailed analysis of the privatization process, see Åslund (1995).

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a tiny percentage of the Russian population has grown rich through privatization, many emerged from the early 1990s with property interests, such as an apartment, a dacha, or stock in an enterprise or investment fund, and with a desire to retain that property and pass it on to their children. Wealth accumulation, which had not been part of the official ideology of the Soviet Union, became acceptable. Resentment of ostentatious displays of wealth stemmed more from a widespread perception that it resulted from criminal enterprise than from the utopian Leninist commitment to the levelling of society.

Moreover, these changes in the political and economic systems have come at a time when the integration of the global economy is creating ever greater pressures for standardization (or at least harmonization) among nations with regard to laws governing commercial transactions (Breeden, 1993; Shapiro, 1993). This pressure is most often exerted by outsiders, such as international financial institutions and investment banks (Head, 1996, pp. 218–26). Russia's precarious financial situation, and its need for credits and loans, require it to take seriously any outside "suggestion" about laws that ought to be promulgated (Shokin and Ryzhkov, 1996). The desire of Russian businessmen to participate in international business transactions and to secure capital investment might create a constituency within Russia for this sort of standardization which, over the long run, might lead to formal legal rationality.  

REWITING THE RULES OF THE GAME

More important than whether existing theory suggests that political and economic conditions in post-Soviet Russia are favorable for evolution toward a formally rational legal system is the question of whether any progress in that direction has been made or is imminent. Progress can best be judged through a series of increasingly difficult questions: (1) are the laws and legal institutions necessary to carry out market transactions on the books? (2) is legal reform entirely state-directed or has it been initiated from the bottom up? and, most critically, (3) have the reforms prompted a change in behavior toward greater reliance on law?

**Formal Legal Reforms**

The changes made to the Russian legal system during the past decade have been both fundamental and far-reaching (Solomon, 1995). They include the passage of legislation that provides a framework for the creation of private legal entities and for the carrying out of commercial transactions (Sukhanov, 1995; Kuznetsov and Braginskaya, 1996; Braginskaya, Kuznetsov, and Sinyukhina, 1996). Major changes have also come

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21Contrast the optimism of Boycko and Shleifer (1995) and de Sellers (in *The International Herald Tribune*, October 18, 1996), about the potency of Russian entrepreneurs' desire to be integrated into the global economy, with first-hand accounts of how foreign businessmen are "learning to work with Russians on Russian terms" (Collins in *Moscow Times*, June 4, 1997).
to the judicial system, both the courts of general jurisdiction (Huskey, 1997) and those hearing economic disputes—the arbitrazh courts (Hendley, 1997). The pervasive influence of the Communist Party has been eliminated. New institutions, unnecessary under the Soviet administrative-command system, but commonplace in advanced industrialized market economies, have been created, such as commissions dealing with antitrust (Joskow, Schmalensee, and Tsikano, 1994), bankruptcy (Williams and Wade, 1995), and securities (Brown, 1995). Indeed, a full listing of the reforms undertaken since the transition began would be prohibitively long.

No doubt gaps exist, but shortcomings can be found in all legal systems. For the most part, the legal infrastructure needed for a market economy has been created—at least on paper. Relatively stable rules exist by which citizens can order their behavior, and institutions have been created that are charged with enforcing those rules. Taken as a whole, the accomplishment is impressive.

The Direction of Reform

But what is the impetus for these new laws and legal institutions? Is the dynamic primarily top-down or bottom-up? For the most part, the legal system has been created in a top-down fashion. Adherents to the Development Argument contend that this is necessary during the initial stages of reform (Blumenfeld, 1996, pp. 479–82). Consequently, they would argue that privatization could only have been conceptualized and carried out in a top-down fashion, and that waiting for it to evolve from below would have been futile (Aslund, 1995; Boycko, Shleifer, and Vishny, 1995). In the end, the unwillingness of legislators to go along with the reformers’ vision led to the bulk of the program being set forth initially via presidential decree rather than legislatively.

Economic actors might have understood the introduction of privatization by decree very differently. Changing the rules of the game by decree is a familiar pattern from the Soviet period, and was likewise common under the Russian tsars (Yakovlev, 1996, pp. 20–21, 85, 139–41, 220). The top-down nature of privatization may have sent a message that law remained a tool to be used primarily by the state, as has traditionally been the case in Russia (Gray and Hendley, 1997). Thus, notwithstanding the fundamental substantive changes introduced, Russians may perceive the role of law as unchanged, as a sword still brandished by the state, rather than as a shield protecting society.

In the wake of privatization, new laws have been generated at a dizzying pace. With a few notable exceptions, the impetus continues to come from above. The laws that have grown out of demands from below tend to be anti-market in their substance. For example, Russian businessmen spearheaded the passage of the law on financial-industrial groups (Borcharov, 1996). This law legalizes the creation of various types of alliances among Russian businesses and banks (O finansovo-promyshlennykh grupppakh, 1995). Sometimes they are presented as a mechanism for increasing efficiency. In reality, financial-industrial groups represent a return to Soviet-style industrial organization, in which the entire chain of production is controlled centrally. As I discuss below, this sort of law tends to lessen the need for arms-length commercial transactions and, by implication, the need to rely on law as an enforcement mechanism.

Many laws related to economic development, such as banking and securities legislation, have been demanded not by Russian businessmen but by international financial institutions. In some instances, the release of money from the World Bank or the International Monetary Fund has been linked to the passage of specific laws (Camdessus, 1996). In other cases, receiving technical assistance for much-needed reforms has required the Russians indiscriminately to adopt a Western framework for these reforms, rather than allowing Russian practice to dictate the shape of future institutions. Western experts have undertaken a considerable amount of the legislative drafting work themselves (Aslund, 1995, p. 247). The resulting laws, while typically beyond reproach from a technical legal point of view, are often incomprehensible to the ordinary Russian businessman.

The 1995 law on joint-stock companies is an excellent example of this (Ob aktionernykh obschestvakh, 1996). Western experts on corporate law, funded by USAID, played an integral role in the drafting process. Among other things, the law requires companies with more than one thousand shareholders to elect the members of their board of directors through cumulative voting, rather than through a one-share one-vote system (Art. 66-4). In principle, this protects minority shareholders by allowing them to “cumulate” their shares in order to elect a director who will represent their interests at board meetings (Gordon, 1994). The Western experts who participated in drafting the law have consistently stressed the importance of cumulative voting in the Russian context (Black, Kraakman, 2015).

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19See World Bank (1996, Appendix C), for a prioritized list of laws to be drafted during the life of the “rule of law” loan.

20Hendley et al. (1997) show that Russian businessmen’s behavior is least likely to be consistent with the law when the law has undergone fundamental change.
and Hay, 1996, pp. 262–264). However, this “protection” is meaningful only if those targeted can appreciate it.

In March 1996, as part of an ongoing case study, I spent time with managers at a large (more than 10,000 shareholders) industrial enterprise in Saratov (see Gray and Hendley, 1997). These managers were responsible for preparing the annual meeting of shareholders. Despite having studied the law in earnest and having retained outside counsel from St. Petersburg, they could not understand the purpose or the mechanics of cumulative voting. When I explained the underlying purpose of protecting minority shareholders, they were dumbfounded. They assured me that their shareholders, almost all of whom are workers at the plant, would never believe such an explanation. After decades of unfulfilled promises, first by the Communists and now by the so-called democrats, these workers are wary of regime-sponsored reform programs that purport to help them. It is possible that the primary concern of the drafters was not with ordinary worker-shareholders, who comprise the vast majority of shareholders in Russia, but with the large, Moscow-based institutional investors.

It might be argued that new laws incorporating legal concepts unfamiliar to the Russians, but commonly used in modern commercial transactions, act to spur legal development by forcing businessmen to leapfrog stages in their acquisition of new knowledge. Implicit in the argument is an assumption that the knowledge so acquired will help them gain entry and be competitive in the global market. But this artificial imposition of foreign solutions does little to strengthen the legitimacy of law domestically. Moreover, foreign advisors cannot always predict how “their” solutions will play out in a different context. To return to cumulative voting as an example, some large companies have undertaken consolidations of their stock in an effort to reduce the number of shareholders and thus escape the strictures of the law (Ob aktsionernyi obshchestva, 1996, Art. 74; Teysker, 1997).

A detailed analysis of why Russian economic actors do not actively participate in the legal reform process is beyond the scope of this article. But several reasons can be suggested. The legacy of the Soviet past provides

part of the explanation. For Russians, law continues to be an instrument of the state. Economic actors do not view law as being useful to them, as a mechanism either to advance their interests or to defend themselves from arbitrary acts by the state. Equally important is that law has always been generated in a top-down fashion. Even if Russians were persuaded of the usefulness of law, they might well resist inserting themselves into the legislative process.

This brings us to the most crucial issue: the extent to which law redirects behavior in Russian circumstances.

RELIANCE ON LAW IN ECONOMIC RELATIONS

From a practical and systemic point of view, routine reliance on law by Russian economic actors who are structuring transactions and resolving disputes is more important than their participation in the legislative process. During the Soviet period, businessmen did not rely on law to protect their interests. Legal niceties mattered less than plan fulfillment. To be sure, the form of law was present, in the sense that enterprises concluded contracts with one another and appealed to state arbitrazh in cases of default (Kroll, 1988). But the contractual form was largely empty of substance. Within the realm of the economy, law was not a bulwark, but a malleable instrument available exclusively to the state. What enterprise managers learned was that their protection came not from the force of law, but from their political connections and their ability to bring pressure to bear on their trading partners. As the chairman of the arbitrazh court in Saratov explained, Soviet managers believed they had three routes of recourse in case of economic disputes: Moscow, the obkom, or the local newspaper. He openly acknowledged that submitting the dispute to arbitrazh was viewed as a waste of time.

The Development Argument implies that privatization and other reforms have caused a shift in longstanding behavioral patterns. Filling in the details of the argument is not difficult. The assumption is that Russian businessmen are able to see that law acts to lower their transaction costs and that, as rational actors, they will shift from a reliance on personal connections and patron-client networks to a reliance on the impersonal rules and institutions that have so painstakingly been put into place. On its face, the argument seems logical.

8 Cumulative voting allows each shareholder to cast votes equal to the number of shares held, multiplied by the number of directors being elected. The managers worried that the calculation would prove too difficult for their shareholders, and that a high number of ruined ballots (bygallteny) would result in the absence of a quorum for the meeting. No resolution of the problem was necessary in 1996. A technicality in the law allowed them to avoid the election of directors because their current board had been elected in 1995 for two-year terms. For 1997, they have decided to have the shareholders fill in percentages on the ballot rather than actual numbers of shares.

24 Many Russian joint-stock companies are dominated by worker-shareholders (Blasi, 1995).

2A constant theme is the concern to protect outside investors (such as investment funds), to gain them representation on boards of directors, and potentially even to oust carry-over managers. See Black, Kraakman, and Hay (1996); Blasi and Shleifer (1996); Boycko and Shleifer (1996); Boeva and Dolgopiatova (1994); Blasi (1995); Pistor (1995); Shleifer and Vishney (1996).
The flaws become apparent only when it is examined through the eyes of Russian businessmen. For them to believe in the sanctity, or even the usefulness, of law requires a huge leap of faith. The role of law as handmaid to politics during the Soviet era is well-documented and deeply engrained in the psyche of Russians. The overblown rhetoric of reform is also familiar from Soviet times (Feifer, 1964), which might explain why the commitment of Yeltsin (and Gorbachev before him) to building a state based on the rule of law (pravovoe gosudarstvo) has had so little impact on attitudes. Given that law is an inherently interactive process, attitudes towards the legal system have a decisive influence on the willingness to use it.

To be sure, Russian businessmen behave rationally. But that is not the same as behaving like Western businessmen. In theory, the concept of rationality is content-free, and connotes only interest-maximizing behavior (Bates, 1983, pp. 134–35). Thus, rationality is not a standard fixed by Western experience, but varies depending on specific circumstances and perceptions of the viability of various courses of action. Rationality is bounded by experience (Nelson and Winter, 1982, p. 35). If Russian economic actors have consistently seen law being used as a tool of the state, then changing their behavior and embracing law on the basis of reforms that, for the most part, have yet to be realized makes little sense (see Hendley et al., 1997).

What I have found in conversations with Russian businessmen is that they understand the argument that law increases efficiency, but they do not believe it is relevant to their circumstances. They do not believe that using law will promote their interests. The concept of law as a relatively neutral and stable set of norms by which they can organize transactions is foreign to them. These businessmen are similarly suspicious of courts, both as a result of their institutional shortcomings and their long record of serving the interests of politics rather than doing justice.9

How do Russian enterprise managers handle disputes? A comparative illustration is in order. Assume a contractual dispute has arisen that, if not resolved, could threaten the well-being of the plant. In the United States, we would expect negotiations between the parties, with a failure to reach agreement resulting in a ratcheting upward of the managerial level participating, leading ultimately, if necessary, to negotiations between the presidents of the two companies.8 We would expect that the wronged party would threaten legal action at some point. Indeed, if the presidents were unable to settle the dispute, the next and final step would be court or binding arbitration, depending on the terms of the contract.31

In Russia, the initial stages would be the same, namely negotiations between progressively higher levels of management, culminating in a tête-à-tête between the two general directors. But if the general directors are unable to resolve the problem, their recourse typically is not to the courts, but to extra-legal political pressure. The general director who is seeking compensation appeals to his political patrons to force his contractual partner to pay what is owed.32 Depending on the nature of the plant, this process may be localized or it may extend to national-level political actors. The process is delicate and can be very time-consuming. One such dispute that I have had the opportunity to observe at close range has been going on for more than four years. During that time, the general director has had countless meetings with politicians and bureaucrats in Moscow, and has received countless promises of assistance. Many of these promises turned out to be ephemeral, since they were tied to specific individuals who had their own concerns. The end result is that the enterprise has received occasional bits of money, but much of the debt remains unpaid (Borisova, in Saratov, June 15, 1996, p. 2).

From an efficiency point of view, the behavior just described seems counterproductive. The general director must divert his attention from current production, and spend both his time and political capital begging for help. The task is further complicated by the increased instability among bureaucratic cadres since the transition began. On any given day, a director can no longer be sure which door is the proper one to knock on, or whom he will find behind it. The transaction costs seem immense. Yet the general directors who engage in this behavior are not stupid. How then do we explain it?

One possible explanation is that economic actors are discouraged from going to court by the well-known shortcomings in the capacity of arbitrazh courts to enforce their judgments (Katanyan, in Nizavisimaya gazeta, January 16, 1997, p. 2). To concretize the problem, assume that one enterprise seeks to recover an unpaid debt from another enterprise. Further assume that the plaintiff obtains a judgment in its favor from the arbitrazh court. Finally, assume that the defendant lacks the funds necessary to cover this judgment in its bank account, as is frequently the case in Russia today. What happens? In order to seize assets the plaintiff has to appeal to the "judicial enforcers" (sudebnye ispolniteli) (APK RF, Arts. 197–209; Yakovlev and Yukov, 1995, pp. 404–41). From an institutional perspective, it is important to note that these sudebnye ispolniteli are not part of the arbitrazh courts, 33

This scenario assumes that companies with sustained relationships will strive to avoid entanglement with the legal system (Macaulay, 1963), and that the vast majority of disputes will be settled in some fashion before reaching precipice of court (Felstiner, Abel, and Sarat, 1980–81). It further assumes that a reputation for litigiousness is unappealing to prospective business partners (Kenworthy et al., 1996).

During the Soviet era, the enterprise manager would undoubtedly have appealed to Party organs and/or industrial ministries for help. The basic behavioral pattern, however, is the same.
but are subordinate to the courts of general jurisdiction. Thus, they are physically and institutionally separate from the arbitrazh courts. Their primary bureaucratic allegiance is to the judges of the courts of general jurisdiction with whom they cohabit. When pressed, they first attend to orders issued by these nearby judges. In principle, the sudebnye ispolniteli have the authority to seize property in satisfaction of the judgment, but often lack the experience and/or the financial support to carry out this task. For example, they have no place to house the property seized in advance of sale or auction; their transportation is not provided by the state, meaning that they have to haul the property on public transport or prevail on friends with cars to help them; and their budget does not cover advertisements for the sale of seized property (see Hendley, 1997).

The capacity to implement judicial decisions in economic disputes is a critical element of a functional legal system in a market economy. Although enforcing judgments is a time-consuming process in many legal systems, the shortcomings outlined in the Russian system certainly constitute a serious problem. When I first began investigating the relative non-use of courts in Russia, I assumed that the lack of proper incentives was the key roadblock. Over the past decade, as the incentives have been redesigned through a series of reforms, I have grown increasingly skeptical of the power of this explanation. Over the years, I have talked with enterprise managers about their choice of legal versus extra-legal solutions to problems. Their choices have varied, but rarely do managers cite problems with collection as a reason for bypassing courts.

The key to understanding why these managers prefer extra-legal solutions comes from looking at the behavior from the actor’s point of view. Maintaining familiar patterns of behavior is easier and can even be comforting. This is also true from the point of view of the enterprise. Organizations are “much better at changes in the direction of ‘more of the same’ than they are at any other kind of change” (Nelson and Winter, 1982, pp. 9–10). The behavioral patterns, both individual and organizational, have been engrained over generations, and shifts in these routines occur gradually (pp. 14–16). The shift to relying on private contract enforcers is a more logical progression than a shift to relying on law, since it does not force the general director to cede power to impersonal forces. Like political patrons, private enforcers provide a “roof” (krysha) over their clients, acting to protect and advance their interests. As Shlapentokh (1996, p. 402) notes, this phenomenon is not unique to Russia, but “probably nowhere has the notion of ‘roof’ had such an immense impact on political and economic processes as in Russia, where it has become an institution successfully competing with the official state.”

But it is not just that relying on third parties (whether political patrons or private enforcers) is familiar. Also relevant is the fact that their trading partners are also behaving this way. Shifting to a reliance on universalistic rules and institutions—submitting disputes to the courts—makes sense only if the shift is made almost simultaneously by a fair majority of economic actors. Absent such a collective shift, a director is naturally reluctant to risk his trading partner going outside the legal system and bringing political pressure to bear, thereby putting the director at a disadvantage. The safer course of action for a director is to forestall that risk by appealing to his patrons. It is a classic dilemma of collective action.

At the heart of the director’s behavior is a desire to retain power. Currently, virtually all power is lodged with the general director. Only he has the connections necessary to exert political pressure on a trading partner and thereby resolve a dispute. He sits at the center of concentric webs of influence. To some extent, his power today is far greater than during the Soviet era, when he had the Communist Party and the ministries looking over his shoulder. He also benefits from the strong vertical hierarchy and the principles of one-man management (edimonalchiality) instilled during the Soviet period (Berliner, 1957). All of these factors combine to create an atmosphere in which the general director is unassailable (Shlapentokh, 1996, p. 394). From a technical legal point of view, he answers to the shareholders, but they have little real power (Blasi and Shleifer, 1994). In some absolute sense, he answers to the market, but the nascent Russian market has demonstrated very weak disciplinary powers.

Given this state of affairs, why should the general director resort to law? By doing so, he will be resorting to rules and institutions that, at least in principle, are not responsive to his power. In the short run, the failure of Russian general directors to embrace existing law and to demand more law is in their interests. It might be argued that continued reliance on patron-client networks demonstrates a lack of vision, an inability to comprehend the long-term cost to the enterprise of being limited to commercial transactions within a circle of friends. Objectively, this is true. A world in which contract enforcement depends on personal connections is necessarily smaller than one in which reliance is placed on impersonal laws and institutions. But few Russian enterprise directors have the luxury of worrying about the long run. Simply surviving in the short run is their primary concern (Ickes and Ryterman, 1994; Boeva and Dolgopolova, 1994). And,

30Complaints about underfunding have been voiced not just by the sudebnye ispolniteli, but by representatives of all key Russian legal institutions (Karayan, in Nezvazhayu gepozit, January 16, 1997, p. 2; Sudebnyaya, 1996). In a year-end decree, Yeltsin promised to make up shortfalls for 1996, and guaranteed to keep the courts fully funded during 1997 (Ukaz, 1997). Such complaints are not unique to Russia, but are perennial in most legal systems (Krawarik, in St. Louis Post-Dispatch, October 6, 1996, p. 38; Stirling, in Milwaukee Journal Sentinel, October 4, 1996, p. 3; Walker and Barrow, 1985). The question is not whether the funding level is ideal or even optimal, but whether financial shortfalls have compromised the functioning of the legal system. The chairman of the Higher Arbitrazh Court recently commented that the arbitrazh courts “were becoming civilized” (Semenova, in Kommersant-Daily, February 20, 1997, p. 4).

31Conversations with Russian workers over the past five years reveal persistent complaints about the unreachability of managers. During the Soviet period, workers could voice complaints to the Communist Party system, and could expect some response. With the transition, workers feel that managers are accountable to no one.
as the stories of widespread wage delays and mounting interenterprise
debt illustrate, survival is far from guaranteed.35

Indeed, the sorts of survival tactics adopted by enterprise directors tend
to push them away from reliance on the formal legal system. The illiquidity
of many enterprises has forced them to resort increasingly to barter.36
Ideally, such a transaction involves two enterprises trading goods of rela-
tively equal value. More complicated (and more common) is the situation
in which one enterprise has no use for the goods received, and so has to
find a third party that wants them and, in turn, has something useful
to trade. The resulting transaction can become quite Byzantine, involving
as many as ten iterations before the original enterprise finally receives some-
ting of value. The organization of such barter transactions obviously
requires the maintenance of reliable networks of personal connections
(Hendley et al., 1997). Unraveling them is virtually impossible, since often
they involve side promises not directly related to the trade at issue. Like-
wise, litigating them is virtually impossible, since the arbitrazh court relies
almost exclusively on documentary evidence.37 Also militating against
instituting legal action over barter transactions is the desire to maintain
good relations with trading partners.

This glimpse into the mindset of Russian general directors also helps
explain why they prefer turning to the “mafia”38 for contract enforcement
rather than relying on the courts (Leitzel et al., 1995).39 Resorting to the legal
system leaves the director at the mercy of a judge who decides the case
based on the evidence and guided by the law. In theory, status considera-
tions are irrelevant.40 In contrast, calling upon private contract enforcers—

35 A number of Western commentators contend that the death of the gigantic enterprises built
under state socialism would be a blessing in the long run (Aslund, 1995; Aghion, Blanchard,
and Burgess, 1994, p. 1359). In the short run, however, these so-called “dinosaurs” provide
the only safety net for many Russians, particularly in smaller towns that are dependent on a
few (or sometimes only one) large enterprise.

36 Illiquidity has become a fact of life in Russia. The results of a January 1996 survey of 1,670
industrial enterprises revealed that 42 percent of their trade was through non-monetary
exchange, including barter and payment by various types of negotiable instruments (Ilarionov,
and Woodruff (1996) report that in-kind payments for tax liabilities have become routine.

37 In principle, arbitrazh courts can accept oral testimony (APK RF, 1995, Art. 69), but it is not
common. Most arbitrazh cases are decided based solely on the documents submitted. As a
general rule, if a claim made by one of the parties cannot be substantiated by written
evidence, then the court will refuse to consider it. See generally APK RF (1995, Arts. 52-74)

38 The use of quotation marks indicates my intention that “mafia” be construed very broadly,
as it is in ordinary Russian discourse (Hendelman, 1995, pp. 21-22).

A4) documents similar practices in Japan.

40 See Hendley (1996, chap. 5) for a discussion of the thorny question of judicial independence
in the Russian context.

whether a security force internal to the enterprise or an outside group—
does not diminish the power of the director, though it may create obliga-
tions that have to be fulfilled in the future. The director continues to pull
the strings. Private contract enforcement merely constitutes a new instru-
ment at his disposal.

As a general matter, the response of Russian economic actors to the
uncertainties produced by the ongoing transition is not to trust in the
reconstituted legal system, but to gain security through vertically integra-
ting with their suppliers.41 These efforts initially built on the foundations
of the Soviet-era ministries and took the form of “kontserny” (Kroll, 1991).
Financial-industrial groups have now become the preferred form (O fin-
ansovo-promyshlennykh gruppakh, 1995; Halligan, in Moscow Times, Jan-
uary 1, 1996; Kryshтановskaya, in Izvestiya, January 10, 1996, p. 5), with
the full support of the Yel’tsin regime (Ukaz, 1996; Milanchikov, in Rossiiskaya
evst’i, May 7, 1996, p. 1–2). There is, of course, some irony in this choice
since, as Shapiro (1993, p. 39) points out, “[v]ertical integration was the
capitalist equivalent of socialist central economic planning . . . .”42

Although the founders of these groups often compare them to Western
conglomerates, they more closely resemble Soviet-era ministries (Narysh-
kin, in Segodnya, October 1, 1996, p. 11).

Vertical integration can be an effective mechanism for reducing trans-
103–14), and can take many forms.43 It eliminates the need for arms-length
contractual relations among the participants in a single production process.
Transactions are governed by rules that are promulgated and enforced
internally, thereby enhancing the general director’s power. Moreover, ver-
tical integration makes sense in conditions where money is in short supply;
it diminishes the need for complex barter transactions.

41 The term “supplier” should be construed broadly to include not only suppliers of raw
materials and finished goods needed for production (Kryshтановskaya, in Izvestiya, January
10, 1996, p. 5), but also suppliers of services, such as contract enforcement (Shilapentokh,
1996).

42 The parallel to the Brezhnev-era policy of amalgamating enterprises into “production
associations” (proizvodstvenye obschestva) is also inescapable (Il’in, 1973).

43 Vertical integration may contemplate full legal and administrative integration through
the merger of two or more companies into a single entity (Chandler, 1977) or it may envision
a less formal arrangement grounded in custom and practice (Macaulay, 1991). The Russian
variant of financial-industrial groups is relatively flexible. Such groups must be registered
with the state, but members may maintain their separate corporate identities and contribute
only a portion of their assets to the furtherance of joint projects (O finansovo-promyshlennykh
gruppakh, 1995). The most prominent examples of such groups are in the gold (Narysh-
kin, in Segodnya, October 1, 1996, p. 11), oil (Koshkareva, in Nasosnaya gazeta, September
24, 1996, p. 4), and aviation (Gorn, 1996) industries. Other industries are consolidating their
resources, but have chosen not to register officially.
CONCLUSION

Merely rewriting the rules and reforming legal institutions, while necessary, is not sufficient to change behavior. Changes in the incentive structure will operate to increase reliance on law only when embedded in the context of a state possessing political authority and an economy based on a functioning market. Neither is present in contemporary Russia. The Russian state has had great difficulty exercising the basic functions of a state, including the enforcement of judgments. A credible threat of coercive action by the state if law is disobeyed, people tend to pay little attention to changes in legal rules and institutions and to look elsewhere for assistance in enforcement (Tyler, 1990).

Russian economic actors have a long history of doing business without relying on law. Under the administrative-command system of the Soviet period, politics consistently trumped law. With the introduction of market mechanisms, these economic actors have adapted their old tactics of using patron-client networks rather than shifting to a reliance on law. Their behavioral patterns or routines are supported by a set of informal norms that are well understood by all but remain unwritten. These routines persist, even though the institutional structure has been almost completely transformed (Yakovlev, 1996, p. 128). Trust, and not legal guarantees, is the glue holding together commercial relationships. Changing these well-established behavioral patterns will require more than passing new laws and/or reforming or creating new institutions. This is not to minimize the importance of such reforms, but rather to place them in perspective. Rewriting the rules of the game is necessary but not sufficient. Rhetoric about the importance of law currently falls on deaf ears. Russians have not been persuaded of the usefulness of law. Without greater attention to state-building and the development of legal culture, Russia stands in grave danger of becoming a country with an excellent legal system on paper, but one that remains largely irrelevant to business.

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44The reasons for the low level of state capacity are not relevant. Regardless of whether the proximate cause is officialdom’s pursuit of private interests (Shlapentokh, 1996, p. 399) or more fundamental flaws in the institutional framework (Solnick, 1995), the impact is the same.

45Some would argue that the same statement could be made about the United States. For me, the critical difference is that law serves as a safety net, giving American businessmen a set of options not available to Russians.

46Whether a reliance on law is a sine qua non for economic development remains an open question. Milhaupt (1996, p. 4) argues that “law is conspicuous by its absence” in Japanese commercial relations.


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