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# Violence, Corruption, and Demand for Law

Throughout the world, firms employ a variety of strategies to secure property rights. As recognized since Macaulay's (1963) pioneering work, many of these strategies do not rely on formal legal institutions. Firms turn to litigation or law enforcement only as a last resort, preferring instead to resolve conflicts on the basis of personal relationships and informal norms. But under certain conditions, firms eschew formal legal institutions in favor of more nefarious strategies – strategies that utilize violence or corruption.

During the California Gold Rush of 1848, for instance, Umbeck (1981, p. 100) found that "the ability to use violence was the basis for all property rights" and therefore "every miner carried at least one gun." In a more contemporary setting, De Soto (2003, p. 155) documents how many Peruvian firms rely on "the protection that local bullies or mafias are willing to sell them." In Indonesia, private security companies not only fulfill the more prosaic tasks of guarding land and buildings but also offer a wide range of services, including "the intimidation of a client's business rivals" (Wilson, 2010, p. 255). Even in some of the world's most developed economies, firms rely extensively on private coercion. According to Milhaupt and West's (2000, p. 66) analysis of Japan, "the influence of organized crime is readily apparent in bankruptcy and debt collection, property development, dispute settlement, shareholders' rights, and finance." And in post-Soviet Russia, the primary focus of this book, violence in the 1990s reached such proportions that approximately two-fifths of surveyed enterprise managers reported personally facing coercion or threats of physical harm in the course of doing business (Radaev, 1999, pp. 36–40).[1]

In addition to violence, firms frequently rely on corruption to secure property, offering informal payments to state officials in exchange for

[1] Further details about this survey are provided in Chapter 3.

protection or for illicit raids against competitors. Wank (2004, p. 113) finds evidence in China of "entire [government] bureaus defining their practical policies and operating procedures to support private firms in ways of varying legality." Meanwhile, in Uganda elected officials serving on Local Councils collect informal fees to resolve property disputes, despite government efforts to move such conflicts into formal adjudicatory institutions provided by the state (Joireman, 2011, pp. 62–66). In Kyrgyzstan, according to one Bishkek-based journalist, "conflicts about property . . . are impossible to resolve if you do not have contacts with the president or with high-ranking officials" (cited in Spector 2008, p. 163). And in post-Soviet Russia, reliance on corruption, like the use of violence, has been particularly prevalent, with law enforcement and former KGB agents frequently acting "informally as private enforcers" on behalf of firms engaged in business disputes (Volkov, 2002, p. xii).

One might expect that once economies become mired in violence or corruption, these dire circumstances would persist indefinitely, or at best evolve toward formality over many years as societies gradually modernize. Yet in unexpected places and at unexpected times, firms rapidly and dramatically turn from illegal to legal strategies for securing property. Contrary to persistent stereotypes regarding the lawlessness of Russian capitalism, post-Soviet Russia is one of these unexpected places. Between 1994 and 2000, the number of annual court cases initiated by Russian firms increased from around 200,000 to just under 350,000. It then shot up to over one million by 2010 (VAS, 2011). More broadly, based on in-depth interviews with firms, lawyers, and private security agencies, as well as an original survey of enterprises from eight cities, this book demonstrates that many Russian firms substituted mafia enforcers with lawyers and replaced violence with lawsuits beginning in the late 1990s.[2] Whereas surveys of Russian firms from the 1990s indicated that around 40 percent of respondents had suffered from violent incidents (Radaev, 1999, pp. 36–40), the survey I conducted in 2010 (discussed below) found that less than 5 percent of respondents had endured a similar fate. Even fewer respondents had faced encounters with the criminal protection rackets for which Russia became infamous in the early 1990s. By contrast, 46 percent of firms participating in my survey had utilized the court system in the last three years.

[2] To be sure, some of firms' use of courts involves abuses of formal legal institutions, but as discussed in Chapter 3, non-corrupt legal strategies have become more prevalent than strategies relying on corruption.

## 1.1 The Puzzle

Prominent legal scholars have emphasized that firms' use of violence and corruption *undermines* formal legal institutions, whereas firms' use of courts and law enforcement *reinforces* formal institutions' effectiveness and relevance (Pistor, 1996; Hendley, 1997). If this is true, firm strategies for securing property have important ramifications for the development of the rule of law, and identifying the factors that determine whether firms employ illegal or legal strategies is of utmost importance. A tantalizingly simple explanation would suggest that firms rely on violence and corruption when the state is weak and rely on formal legal institutions when state legal capacity improves. But the examples discussed above demonstrate that firms regularly resort to violence and corruption not only in low capacity states but also in states with reasonable levels of capacity. Consequently, state legal capacity can at most serve as a partial explanation.

Even more curious is that in cases such as post-Soviet Russia, firms mobilize legal resources even when the effectiveness of legal institutions is in doubt – and, in fact, even when state officials themselves pose a major threat to property security. Throughout the period in which Russian firms increasingly turned to formal legal institutions, many observers insisted that lawlessness in Russia remained as prevalent as ever. As William Browder, the largest foreign portfolio investor in Russia until government officials attempted to illegally seize his assets, declared, "Property rights no longer exist . . . with the spectacular recent decline in the rule of law, anything is possible in Russia now" (Browder, 2009). Mikhail Khodorkovsky, the richest man in Russia before his politically motivated arrest in 2003, offered a similar assessment in a 2011 interview from his jail cell, proclaiming: "As concerns rule of law, I know only too well that it does not exist in Russia – the judiciary is not independent at all" (*Wall Street Journal*, June 15, 2011). And while few firms in Russia directly face the wrath of Putin or his close associates, they encounter wide-ranging threats to their property rights from lower-level state officials. Rogue law enforcement officers, for instance, frequently arrest businesspeople on false pretenses, seeking to induce informal payments or illicitly acquire entrepreneurs' assets. By some estimates, approximately 100,000 businessmen are either behind bars or have faced criminal prosecution (Yaffa, 2013).

In short, this book centers on a pair of related questions: Why do firms sometimes resort to violence and corruption to secure property,

even when formal legal institutions are relatively effective? Why do firms sometimes turn to law even without improvements in the state's legal capacity?

## 1.2 The Argument

By bringing firms' role in the development of effective institutions to the foreground, this book sets off in a distinctly different direction from most existing studies of property rights. There is broad agreement among policymakers and scholars alike that institutions for protecting property rights are vital for economic development and societal well-being (e.g., North, 1981; Knack and Keefer, 1995; Posner, 1998; Acemoglu et al., 2001; De Soto, 2003; Cooter and Schaefer, 2009). Nearly all prominent studies of property rights, however, seek to understand the security of property by analyzing the conditions under which rulers and governments develop effective institutions (e.g., North, 1981; Olson, 1993; Acemoglu and Robinson, 2006). By contrast, this book demonstrates that state "supply" of formal legal institutions is a necessary but frequently *insufficient* condition for firms to turn from coercion to law. Consequently, a thorough understanding of property rights security also requires a deeper understanding of the conditions under which firms are willing to *use* formal legal institutions, an issue sometimes referred to as private sector "demand" for law (Pistor, 1996; Hendley, 1999).

This book offers a theory of institutional demand and a framework that integrates the supply and demand sides of property security. First, I argue that while a dearth of *state legal capacity* may impede firms' use of law, improved capacity frequently does not increase firms' willingness to utilize formal legal institutions. Institutional supply, in other words, does not automatically create institutional demand. This first component of my argument builds on studies by Pistor (1996) and Hendley (1997, 1999), who lay the groundwork for analysis of why private actors may refrain from using legal institutions.[3] Advancing their foundational work, this book also elaborates the conditions under which firms *do* turn to law. In particular, I emphasize that increasing reliance on formal legal institutions frequently occurs in the absence of heightened state legal capacity. In such cases, two factors other than state legal capacity largely determine whether firms utilize violence and corruption or whether firms

[3] See also the insightful discussion about supply and demand for law in Milhaupt and Pistor (2008, 40–44).

turn to law: the prevalence of *demand-side barriers* to using formal legal institutions and the *effectiveness of illegal strategies* for securing property. Demand-side barriers are behaviors or beliefs at the level of firms and individuals that lead these actors to avoid formal legal institutions. As discussed in Chapter 2, prominent barriers include firms' operations in the informal economy, expectations about other firms' reliance on violence or corruption (which lead to collective action problems), and cultural norms. Meanwhile, as with any competing set of services, firms' willingness to use formal legal institutions depends on the effectiveness of alternatives. In the case of illegal strategies, effectiveness largely depends on transaction costs relative to other strategies and the risk of sanctions for illegal activities.

I also demonstrate that to understand institutional demand, it is necessary to develop a more nuanced understanding of institutional supply. The direct supply of institutions is only one way in which the state affects firms' willingness to use law. The state also indirectly – indeed, sometimes even inadvertently – influences firm strategies by altering demand-side barriers or the risks associated with illegal alternatives.

## 1.3 Contributions

Through empirical analysis of the role of violence, corruption, and law in the protection of property rights in post-Soviet Russia, this book offers broader insights into several pressing lines of inquiry in contemporary comparative politics and political economy.

First, while the importance of the rule of law – and secure property rights in particular – to economic and political development is widely recognized, it remains unclear why institutions for protecting property rights remain ineffective in much of the world. By emphasizing the demand side of institutional development and by analyzing the interaction between institutional supply and demand, this book provides a fresh perspective about the rule of law's institutional underpinnings. Moreover, this book's focus on institutional demand complements but also bridges important gaps left unfilled by existing studies on property rights, which concentrate largely on (1) how states supply institutions or (2) property protection in the absence of effective state institutions.

In contrast to this book's emphasis on how firm strategies for protecting property can hinder or promote institutional effectiveness, the most influential existing studies examine rulers' incentives to facilitate or undermine the security of property rights (e.g., North, 1981; Levi,

1989; Olson, 1993; Acemoglu and Robinson, 2006). These studies find that institutions for protecting property will be more likely to develop when rulers expect to remain in power for the long term, possess effective technologies for monitoring and taxing assets, expect their grip on power to survive destabilization that may accompany economic development, and depend on the skills or resources of private citizens. Yet despite this literature's substantial contribution to our understanding of property rights, the supply-side approach offers incomplete insights because it fails to address the fundamental question of when firms turn to formal legal institutions to protect property rather than resorting to violence and corruption.

The sizable literature on how firms protect property in the absence of effective state institutions, meanwhile, sidesteps altogether the question of when firms use formal institutions (e.g., Greif, 1993; McMillan and Woodruff, 1999; Haber et al., 2003; Markus, 2012, 2015). These studies demonstrate that mechanisms such as repeated interactions between buyers and sellers, private business networks that transmit information about merchants' reputations, and defensive alliances between firms and foreign investors or business associations can help secure property and enforce contracts. While the non-state property rights literature addresses issues of great importance, prominent scholars agree that in complex, modern economies informal institutions can rarely serve as effective substitutes for formal institutions on a large scale (e.g., North, 1990, ch. 6; Ellickson, 1991, pp. 249–254). Unfortunately, the issue of how such formal institutions develop falls outside the research agenda of the non-state literature.

Beyond the rule of law, a study of property rights from the firm's perspective provides distinctive insights into the social and political foundations of state capacity. Following Migdal's (2001) "state-in-society" approach to the study of state building, this book suggests that state capacity – the ability of states to implement policies and enforce rules – depends not only on rulers' policies but also on societal actors' strategies. As noted above, firms' reliance on violence and corruption undermines and destabilizes formal institutions. Their utilization of courts and law enforcement, on the other hand, reinforces the effectiveness and relevance of formal state institutions. Phrased differently, state building is not simply a top-down process of developing and imposing institutional blueprints on society. Rather, it is also a bottom-up, ongoing process involving the daily interactions of numerous "ordinary" social actors both

with each other and with representatives of the state.[4] Moreover, while my specific focus is on firms' strategies for securing property, scholars such as Grzymala-Busse (2007, 2010) have demonstrated more broadly that societal actors' strategies have a significant impact on a wide range of formal institutions, including civil service regulations, national auditing offices, and anti-corruption laws. She, too, finds that informal practices have the potential to either replace and undermine formal institutions or, when the conditions are right, to "reify formal rules . . . by providing incentives and information to follow formal institutions" (Grzymala-Busse, 2010, p. 311). The demand-side approach developed in this book therefore offers general lessons about the conditions under which formal institutions transcend mere words on paper: Namely, effective formal institutions emerge not simply when states invest in capacity, but also when barriers to citizens' use of formal institutions are removed and steps are taken to diminish the effectiveness of illicit alternatives to formal institutions.

In addition to broader inquiries in comparative politics and political economy, this book contributes to ongoing debates pertaining to the post-communist region. In contrast to the theoretical literature on property rights, scholarship on post-communism has been relatively more attuned to demand-side issues. Key early works by Pistor (1996) and Hendley (1997, 1999) examined firms' use (or lack thereof) of the court system, as well as private sector actors' attitudes toward law more broadly. Shortly thereafter, economists – puzzled by the seeming paradox that many Russian firms appeared *not* to support the development of secure property rights – produced a series of formal models to analyze the issue. For example, Polishchuk and Savvateev (2004) and Sonin (2003) demonstrate that given high levels of economic inequality and weak state institutions, richer and more powerful firms have the incentive to pay for private protection while seeking to maintain the weakness of formal institutions. This environment allows them to guard their own assets while expropriating weaker citizens' wealth. In a related vein, Hoff and Stiglitz (2004) examine how each actor's expectation that other actors will subvert institutions creates further incentives to abandon law and order. They emphasize how factors such as dependence on natural resources and high levels of corruption, which increase individuals' incentives to engage

[4] Even in advanced industrial countries, recent studies show that strategies of firms play an important role in shaping state capacity. Hall and Thelen (2009, p. 16) emphasize, for example, that "shifts in firm strategy can erode the viability of some institutions and strengthen others."

in rent-seeking rather than productive investments, can lead countries like Russia to become stuck in an unlawful equilibrium.[5] However, these models are significantly limited by their focus on macro-level explanatory variables. Economic inequality, natural resource dependence, and corruption have become more acute over the last decade and a half, yet during this period Russian firms have increasingly employed legal strategies. Meanwhile, although Pistor (1996) and Hendley (1997, 1999) offer valuable insights regarding potential factors that influence institutional demand, to date there exists no comprehensive empirical treatment of institutional supply and demand in the post-communist region.

Finally, this book seeks to integrate two divergent viewpoints on institutional development in Russia. At one extreme, scholars such as Volkov (2004, 2005) and Ledeneva (2006) perceive nearly all use of formal legal institutions to involve some form of strategic corruption, in which firms use ties with the state to turn formal institutions into private tools rather than neutral enforcers and adjudicators. These scholars therefore are frequently dismissive of claims regarding positive developments with respect to the rule of law in Russia. At the other extreme, scholars such as Solomon (2004, 2008) and Hendley (2006, 2012), while explicitly recognizing the limitations of Russia's legal infrastructure and persistence of illicit practices, paint a much more sanguine picture of the everyday workings of law in Russia. By presenting a unified framework that gives equal emphasis to violence, corruption, and law in Russia, this book provides insights into the conditions under which firms are most likely to turn to each.[6]

## 1.4 The Case: Post-Soviet Russia

Why focus on Russia during the two decades following the Soviet Union's collapse in the early 1990s? The theory of institutional demand developed in this book offers general insights about the interactions among state legal capacity, demand-side barriers, and the effectiveness of alternatives to formal legal institutions. However, Russia's post-Soviet era, a time

[5] It should be noted that these models focus on private actors' influence, either as voters or lobbyists, on the *creation* of formal institutions rather than on firms' *use* of institutions. There also is a small empirical literature on "demand for law" in the form of private sector lobbying for institutional reform in Russia, particularly during the early Putin period of 2000–2003. See, e.g., Jones Luong and Weinthal (2004); Guriev and Rachinsky (2005, pp. 145–148); Markus (2007).

[6] Frye (2017) offers a broad analysis of informal and formal strategies for securing property but focuses on various strategies' effectiveness, rather than on the factors contributing to firms' strategy choices.

period during which Russia was undergoing a dramatic transformation from a socialist command economy to a market economy, offers particularly illuminating insights on institutional demand. Few countries have witnessed such a wide range of firm strategies for securing property, especially in the compact span of two decades. This range of strategies provides fertile material for generating hypotheses about when firms turn to formal legal institutions, and when firms employ violence or corruption.

In all market economies, firms face a variety of challenges related to enforcing contracts and protecting property. Suppliers violate the terms of contracts. Buyers fail to make payments on time. Founding partners of firms engage in ownership disputes. Minority owners in corporations contest violations of their shareholder rights. Tax officials and regulatory authorities issue decrees that infringe on firms' income streams or devalue firms' assets.

But while conflicts related to contracts and property rights are an inevitable part of market transactions, the nature of such disputes often has assumed extreme forms in post-Soviet Russia. In 1994, the Russian Ministry of Internal Affairs recorded more than 500 contract killings, the majority of which involved commercial disputes (Statkus, 1998). In 1996, one survey of Russian shopkeepers revealed that more than half of these respondents had faced recent encounters with mafia extortion rackets (Frye and Zhuravskaya, 2000). Beginning in the late 1990s, Russian firms faced a wave of "illegal corporate raiding" (*reiderstvo*) involving the theft – quite literally – of entire enterprises. Examples included forging a company's shareholder registry or exploiting legislative loopholes to bankrupt financially healthy firms and then loot their assets in the guise of compensating creditors. Meanwhile, from the mid-2000s onward, countless entrepreneurs faced arrest on trumped-up charges as law enforcement officials, acting on their own behalf or on the behalf of paying private clients, sought to acquire firms' assets at below-market rates or eliminate their clients' competition.

Collectively, I refer to firms' efforts to resolve conflicts related to acquiring assets, protecting property, and enforcing contracts as *property security strategies*. I develop this concept more fully in Chapter 2, where I discuss how it relates to common terms such as "property rights" and the "rule of law" and provide a typology of strategies based on the extent to which a strategy is backed by private or state coercion. For the moment, a schematic illustration of the evolution of Russian firms' strategies for securing property offers a starting point for the analysis to come.

At one end of the spectrum are property security strategies that rely on coercion provided by private actors. Russian firms' widespread reliance in the early 1990s on the services provided by organized crime groups and private security agencies – often staffed by former military, law enforcement, or KGB personnel – provides the most clear-cut case of strategies based on private coercion. Private providers of property security offered what the sociologist Vadim Volkov refers to as an "enforcement partnership," or what became known in colloquial Russian as a *krysha* – literally, the Russian word for "roof," in reference to the protection such a relationship afforded to businesspeople. Aside from physical protection, *kryshas* provided an extraordinary range of services: accompanying convoys of physical goods in transit, acquiring information on prospective suppliers or buyers, collecting debts, meeting with the *kryshas* of other firms to resolve – peacefully or otherwise – disputes, and even smoothing out relations with tax or regulatory authorities (Volkov, 2002, pp. 49–53, 139–141). During the heyday of private coercion, criminal elements additionally developed complex adjudication arrangements, creating a system of "shadow justice" (Skoblikov, 2001) in which top-level criminal figures, known as *avtoritety*, served as arbiters for ongoing disputes among businesspeople represented by lower-level criminal protectors.

By the late 1990s and early 2000s, Russian firms were less likely to utilize strategies based on private coercion. Yet the manner in which they engaged state actors and formal state institutions frequently was borderline, if not outrightly, illegal. Because these strategies appropriate state resources for private gain, I refer to them as "corrupt coercion" in the typology elaborated in Chapter 2. A short vignette provided by Andrey, the owner of a small business in Moscow, vividly depicts the nature of such strategies. At the time he was interviewed in 2009, this entrepreneur, an importer of high-end accessories for outfitting luxury automobiles, had been operating his business for nearly a decade. Although he operated without a *krysha* for several years, Andrey sought protection after being physically threatened by an extortionist seeking lavish compensation for a car accident that ostensibly resulted from a defective product purchased at Andrey's shop. At the advice of acquaintances, Andrey turned to a firm specializing in "economic security" (*ekonomicheskaya bezopasnost*), the contemporary variant of the semilegal private security agencies of the early 1990s. The security provider had a flashy office, handed out fancy business cards, worked on the basis of formal contracts, and exhibited all the trappings of a professional consulting firm, but it also made no secret of its ties to powerful state operatives, such as the Federal Security Service,