

# **PROMOTING PROPERTY RIGHTS IN RUSSIA:**

## **THE VALUE OF PRIVATE SOLUTIONS**

An NCEEER Working Paper by

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## **Executive Summary**

Most strategies of strengthening property rights focus on public institutions, such as courts and bailiffs. However, private institutions, networks of reputation, and social organizations also play a key role in shaping the quality of property rights. This essay explores the interplay of public and private institutions in promoting trade between firms in Russia. Survey-based experiments of 500 businesspeople conducted in Russia in 2008 find that a good reputation provides a more potent stimulus to trade than does a 15 percent discount in price; that reputation and state-run courts each promote trade; and that reputation and courts are complements rather than substitutes, that is, reputation provides a stronger boost to trade when courts work well and vice versa. Rather than undermining public institutions, private institutions in this case underpin them. The paper concludes by drawing policy implications from the findings.

## **Introduction**

Few dispute that businesses in Russia have weak property rights, but the roots of this weakness are hotly disputed.<sup>1</sup> For many, public institutions, such as Russia's disorganized state and feeble court systems are largely to blame (c.f., Holmes 1996). While not denying that Russia's state courts of arbitration leave much room for improvement, others suggest that Russia's legal institutions and court system perform relatively well when compared to peer countries (c.f., Hendley et al. 2001; Murrell 2003). Indeed, contract enforcement in Russia scored 19<sup>th</sup> best in the world, according to the most recent round of the World Bank's Doing Business in the World Survey.<sup>2</sup>

Debate also surrounds the role of private or informal institutions, such as networks of reputation, gossip, and business associations, in Russian economic relations.<sup>3</sup> Few doubt that firms rely heavily on these non-state means to strengthen their property rights, but it is unclear how to interpret this practice.<sup>4</sup> For some, it is evidence in itself that state institutions in Russia are weak. For others, the pervasive reliance on private means to support trade between firms is a source of weak state institutions (Ledeneva 2006).<sup>5</sup> Yet scholars have argued that private and public institutions that support property rights are typically mutually reinforcing (North 1990).

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<sup>1</sup> Less benignly, private protection organizations that use threats of violence to enforce trade contracts are also a staple of life in many countries. I deal with these issues only tangentially here. See Hendley et al. (2000); Frye and Zhuravskaya (2000) Varese (2002); Volkov (2002); and Frye (2002).

<sup>2</sup> This measure evaluates the formal procedures needed to enforce a contract rather than the de facto effectiveness of enforcing contracts. Other dimensions were less favorable: registering property scored 45; getting credit 87; and trading across borders 182. Overall it is ranked 106<sup>th</sup> down from 88<sup>th</sup> in the previous year.

<sup>3</sup> I borrow (North's 1990: 3) a commonly used definition of institutions here as the "humanly devised constraints that shape human interaction." More colloquially, institutions are akin to the rules of the game, and organizations are the players of the game. See also Knight (1992).

<sup>4</sup> Private institutions refers to institutions in which non-state actors provide rule-making and rule enforcement functions, while public institutions refers to institutions in which state actors provide these differences. This distinction is close to many discussions of formal and informal institutions, but is less ambiguous in many respects.

<sup>5</sup> Ledeneva (2006) focuses on a wide range of informal practices that are individually rational, but socially inefficient.

That is, strong private institutions, such as networks of reputation tend to go hand in hand with strong public institutions, like courts (Putnam 1994).

Despite the importance of weak property rights for Russia's transition, there is much that we do not know. This report explores the role that private institutions, such as reputation, and public institutions, such as courts, play in promoting exchange between firms in Russia. How important is reputation in promoting secure property rights? Does a concern for reputation or confidence in the courts provide stronger incentives to trade? Do private institutions that promote trade undermine or underpin state institutions?

The relationship between public and private institutions in promoting property rights has important implications for public policy. If private institutions and networks of reputation and social trust undermine public institutions by reducing demand for state services, then strategies to promote the rule of law require difficult tradeoffs between supporting public and private institutions (c.f. Migdal 1988; Ledeneva 2006).

Because strengthening public institutions is likely to weaken private institutions and vice versa, the value of efforts to promote the rule of law may be limited. If, however, private institutions that promote trade between firms underpin public institutions, then it is easier to justify devoting scarce foreign aid to develop social organizations that strengthen trust and transmit information about the reputation of firms (North 1990; Putnam 1994; Frye 2000). Doing so will have important multiplier effects by also increasing the capacity of public institutions, such as courts.

This essay uses a survey of 500 firms in Russia in 2008 to explore these questions and inform policy. It presents four main results, each of which modifies conventional wisdom on the status of property rights in contemporary Russia. First, reputation provides a powerful stimulus

to trade. More precisely, a good reputation provides a greater boost to trade than does a 15 percent discount in price. Many studies recognize that private institutions and good reputation are central to trade in Russia and other developing economies, but this essay identifies the magnitude of the impact of reputation on the security of property, and thereby more precisely measures the value of this important private institution.

Second, “word of mouth” and the “local press” are equally powerful in conveying information about a firm’s reputation. This result is surprising given that most observers emphasize the importance of personal networks rather than the free press in Russia as a source of credible information about business practices (Ledeneva 2006).

Third, state-run courts promote trade between firms. While Russia’s courts are often rightfully depicted as weak, the evidence here suggests that nonetheless firms that have more confidence in state courts of arbitration are more likely to engage in trade than those that have less confidence in courts.<sup>6</sup> At least in the run-of-the-mill disputes between firms analyzed here, the state courts of arbitration have an important influence on property rights.

Fourth, courts and reputation are better seen as complements that reinforce each other than substitutes that undermine each other. That is, reputation is a more potent stimulus to trade in the presence of strong courts. Thus, reliance on reputation and private norms is not a sign of weak state institutions, as is commonly argued. Indeed, good reputations and strong state institutions reinforce each other.

These findings are consistent with a critique of “technocratic” strategies for promoting the rule of law and property rights that emphasize strengthening state institutions without taking local private institutions into account (Golub 2006; Upham 2006). This line of argument

encourages policymakers to take advantage of local private institutions as an important means for promoting property rights (Qian 2003). This essay not only emphasizes the value of private solutions to help promote trade, it also takes the next step by examining how public and private institutions interact to shape confidence in property rights.

More generally, this essay answers the call for basic research on the operation of legal institutions in developing and transition countries, especially those who have been the target of intensive efforts to promote the rule of law and property rights. Carothers (2006) rightfully notes that many standard prescriptions to promote the rule of law have remarkably little empirical support in large part due to a lack of basic research.<sup>7</sup> Tellingly, Carothers subtitled a volume of essays on recent work on rule of law reform *In Search of Knowledge*.

Many studies have analyzed the spectacular violations of the property rights of strategically important firms in the natural resource sectors in Russia, but here the focus is on non-strategic firms involved in everyday disputes. By definition, strategically important firms have different relations to state officials than do non-strategic firms, and therefore it is difficult to extend generalizations to other types of firms. The findings here tell us little about disputes involving strategic firms, but non-strategic firms employ the bulk of the population in Russia, provide more than half of GDP, and are critical to efforts to diversify the economy away from the volatile natural resource sectors. Thus, these firms merit close attention.

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<sup>6</sup> Several studies conclude that state courts of arbitration that resolve business disputes between firms and between firms and state officials work better than the courts of general jurisdiction that handle other types of disputes, but this distinction is often lost in discussion of the quality of the rule of law in Russia (Hendley et al. 2001; Frye 2004).

## The Problem of Trade

The exchange of goods and money invariably creates a problem.<sup>8</sup> Unless goods and money are exchanged simultaneously and quality can be determined on the spot, the party that gives up control of their assets first becomes vulnerable to breach. Sellers who receive payment may abscond with the funds without delivering the goods, while buyers who receive the goods before payment may decline to send the money. As each party can anticipate the other's behavior, both sides have strong incentives to decline to trade and miss an opportunity for potential gains from trade.<sup>9</sup> To capture these gains societies have developed a rich variety of public and private institutions that sharpen incentives to trade. Countries that create institutions to prevent disputes and promote trade most efficiently have typically been at the frontier of economic development (North 1990; Knack and Keefer 1995; Acemoglu, Johnson, and Robinson 2001).

All societies rely on a mix of public and private institutions to promote these types of exchange and scholars debate the relative importance of each. Public institutions have the advantage of economies of scope and scale in organizing the coercion necessary to sanction violators of property rights. Few dispute that the development of capable public institutions such as the state is central to economic development (North 1981).

In recent years, however, scholars have paid increasing attention to the role that private institutions play in governing a wide range of trading relationships. Williamson (1985) argues that private firms have considerable scope in designing bilateral private institutions to support

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<sup>7</sup> Carothers (2006:15) quotes one long-time rule of law reform specialist: "We know how to do a lot of things, but deep down don't really know what we are doing."

<sup>8</sup> These problems are hardly unique to the economy. Congressional representatives exchanging support for bills introduced sequentially or parents organizing car pools for their children face similar incentives.

<sup>9</sup> The famous debate over the timing of the payment and receipt of the chair in Ilf and Petrov's classic, *Twelve Chairs*, highlights this problem. "Den'gi utrom ili stulya vecherom?"



trade without having to rely on state institutions. Geertz (1978) identifies information relayed through gossip and social sanctions as critical to promoting trade in the bazaars of Morocco. Others point to social networks, business organizations, professional associations, and ethnic networks as private institutions that provide a means to sanction cheating and promote cooperation without relying on the state for enforcement (Granovetter 1985; Milgrom, North and Weingast 1990; Ellickson, 1991; Ostrom 1992; Bernstein 1992; McMillan and Woodruff 1999).<sup>10</sup> Because even the best-governed state lacks the resources to resolve every potential dispute, private solutions to problems of trade are widespread (c.f. Macauley 1963).

Such private mechanisms may have advantages over public institutions, particularly where the latter function poorly. Market participants may have more expertise than judges, and they can take advantage of information that cannot be used in court (Charny 1990; Johnson, McMillan and Woodruff 2002b: 229). Over the long run the state offers economies of scope and scale that private institutions cannot match, but which are a more potent stimulus to trade in a given setting is not immediately clear.

Observers of Russia have begun to contribute to this debate by studying private and public institutions that shape trading relations. Some have identified trading networks based on long-standing social ties and a concern for reputation as key factors in maintaining production and trade (Gerber and Kharkhodin 1994; Sedaitis 1994; Raiser 1999; Ledeneva 1998, 2006; Hendley et al. 2000; 2001; Frye 2000; Gaddy and Ickes 2003; Pyle 2005). Others have found that state courts in Russia are used more frequently and are more effective than is commonly appreciated (Hendley et al. 2000; 2001; Shvets 2003; 2005; Simachev 2003; Hendley 2004; Frye 2004, but see Hellman et al. 2003; and Berger 2004). As in other settings, however, there is

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<sup>10</sup> Elsewhere in Eastern Europe, Stark (1998) and McDermott (2002) emphasize the role of social networks.

considerable debate about which is more important in protecting rights to trade.

### **Institutions as Substitutes**

Another important debate examines the interrelationship between private and public mechanisms for preventing disputes and promoting trade. One view argues that private and public institutions serve as substitutes. Reliance on private institutions “crowds out” demand for state institutions and thereby limits the resources available to state agents (Frey 1997). When businesspeople in the private sector can overcome the problems that plague trade using private means, like reputation or trust, they express less demand for capable state institutions.<sup>11</sup>

Rather than devoting resources to develop the state, businesspeople will invest in the creation of powerful private organizations to support trade. Bernstein (1992) finds that the traders in the tight-knit community of Orthodox Jewish diamond traders in New York City opposed state regulation even when offered and instead preferred to rely on private means to resolve disputes. Ellickson (1991) argues that ranchers and farmers in Shasta County, California used private understandings of the law rather than public institutions to resolve disputes. On this view, powerful social networks reduce demand for state institutions that resolve disputes. In Russia observers frequently cite the prevalence of informal institutions as contributing to the weakness of the state (c. f. Ledeneva 2006: 11).

On a macro level, countries with strong social institutions that provide many forms of public goods often have difficulty developing capable states. Most prominently, Migdal (1988) characterizes these polities as having “strong societies and weak states.” States and social

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<sup>11</sup> This is a common assumption in formal models that require economic agents to invest in either the formal or informal economy. Investing in the formal economy generates a good equilibrium where firms pay taxes and use courts, while investing in the informal economy leads firms to avoid taxes and use informal protection rackets. See for example, Johnson, Kaufmann and Shleifer (1997).

organizations consistently compete for the authority to make rules for society. Where social organizations are imbued with dense networks of trust they may have advantages over the state. Thus, the micro-level decision studied here may have implications for larger processes at the level of the state and society. The substitution argument suggests that strong private institutions that support trade should be associated with weak state institutions and vice-versa.<sup>12</sup>

### **Institutions as Complements**

A competing argument suggests that private and public institutions are complements. That is, strengthening one increases demand for the other. Strong private institutions and strong public institutions go hand-in-hand in promoting trade. North (1990: 46) argues that “public rules can complement and increase the effectiveness of private constraints.” More broadly, capable state institutions may make reputation and social trust more effective by sharing information about other social actors (Levi 1998; Frye 2000).

Moreover, strong social institutions that rely on reputation may help private agents overcome collective action problems and hold public officials accountable and thereby increase the effectiveness of state institutions (Putnam 1994). Finally, capable private institutions that support trade may ease the burden on state officials by reducing the number of disputes that actually end up in court. This view, which lies at the core of Putnam’s *Making Democracy Work*, suggests that the development of private and public institutions should be mutually reinforcing (Putnam 1994).

Given the importance of the issue and the advantages of studying it in a transition setting, it is not surprising that scholars have begun to explore this topic. Hendley, Murrell, and

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<sup>12</sup> There is a growing literature on laboratory experiments that assess the impact of formal and informal institutions on the propensity to trade. For a good example, see Lazzarini et al. (2004).

Ryterman (2000) conducted an innovative study of 328 business managers in six cities in Russia in 1997 that explored their strategies for resolving disputes. Respondents were asked to rate the “importance of each of the following methods for your firm” for resolving disputes on a scale of 1-10 where the rating should “reflect both the frequency of use and effectiveness” of the different mechanisms.

Respondents rated negotiations as a 7.4 and arbitration courts as a 5.4 on this ten-point scale. The authors found that three-quarters (76.4%) of firms facing disputes with suppliers used negotiations to help resolve the dispute, and about one-quarter (25.5%) turned to state arbitration courts. In addition, they found little evidence of complementarities among negotiations, private meetings between firm representatives, and the use of courts.<sup>13</sup>

Johnson, McMillan, and Woodruff (2002) in a 1997 study of 1500 medium-size manufacturing firms in five post-communist countries find that private institutions, such as personal relationships, are a predominant form of contracting, but that courts play a critical role in promoting trade as well. In a related work based on the same survey, McMillan and Woodruff (2000) found that social networks and gossip substitute for public legal institutions, but that business networks and trade associations complement public legal institutions.

Pyle (2005) uses data from the Johnson, McMillan, and Woodruff survey to find that business organizations help resolve contracting problems, particularly when trading partners are located in other regions. In a study of five markets in Moscow in the 1990s, Frye (2000) finds that when state policy lowered the costs of sharing information sufficiently, brokers created organizations that relied on reputation to support exchange and served as substitutes for state courts.

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<sup>13</sup> Hendley and Murrell (2003) repeated this question in a study of 254 companies in Romania in 2001, and again, found little evidence of complementarities among formal and informal institutions.

## Methodological Concerns

In answering the questions posed in the introduction, scholars face several challenges. First, few studies capture the size of the deterrent effect of public and private institutions on behavior.<sup>14</sup> Courts and social networks that work relatively well may deter violations in the first place and thereby encourage trade. If we only examine disputes, violations of contracts, or cases that actually end up in the court, we fail to identify the important role of public and private institutions in promoting trade by deterring violations in the first place. This is important because businesses are often reluctant to use courts to resolve disputes (for the US, Macauley 1963; for Japan, Haley 1978; for Europe, see Arrighetti, Bachman, and Deakin 1997).<sup>15</sup>

Second, as many have noted, analyzing the impact of courts on behavior by using data about the use of courts is often helpful, but can be problematic because only a small number of disputes with specific features end up in court (Macauley 1963; Hendley et al. 2001). Drawing inferences from a sample of court cases can produce insightful analyses of cases that end up in court, but are less useful for making generalizations about the impact of courts on behavior in other cases because we miss exchanges in which both sides hold up their end of the contract because they expect courts to punish opportunism. In addition, we miss cases where disputes arise, but are resolved before reaching the court. Because very few disputes end up in court, this drawback is quite substantial. In other words, because the cases that end up in court do not represent an unbiased sample of disputes, generalizing about dispute resolution using only court data is problematic.

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<sup>14</sup> The analyses focus only on the ability of the courts and reputation to promote trade prior to a dispute and say nothing about whether courts and reputation are substitutes or complements after a dispute occurs.

<sup>15</sup> The post-communist world offers an excellent opportunity to study these issues. Developed economies are typically marked by strong public institutions and robust private institutions. This makes it difficult to identify how formal and informal institutions influenced each other in their formative stages. By analyzing efforts to construct private and public

Third, institutional analyses have made important advances in recent years, but often confront a difficult problem of joint determination or endogeneity.<sup>16</sup> If good private and good public institutions that support trade are almost always found together, then it is often difficult to draw clear inferences about the extent to which each factor is shaping the security of property rights. For example, one may observe that social trust is high, that courts work well, and that firms comply with contracts. The covariance of public and private institutions makes it difficult to identify the relative effects of each factor in supporting trade. This may be problematic in standard survey questions that ask respondents to rate the extent of social trust, the quality of courts, and contract compliance.

Thus, standard survey questions can identify correlations between social trust and trade and between courts and trade controlling for other factors, but are less useful for making causal claims about how public and private institutions influence the propensity to trade (Kramer 1983).<sup>17</sup> Fourth, case studies have made important contributions to our understanding of the rule of law in Russia, but it is difficult to generalize from case studies that may be unrepresentative of the general population.

This report addresses these shortcomings by using survey-based experiments to identify relationships among reputation, courts, and the propensity to trade. In a survey-based experiment, a researcher creates slightly different versions of a question and then randomly assigns respondents to different versions of the question. Each respondent does not know that others are receiving a slightly different version of the question. When the number of respondents

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institutions to support trade in the post-communist world, we can study the interaction of these institutions before they reach a steady state.

<sup>16</sup> See Acemoglu, Johnson, and Robinson (2001) for more on this point.

<sup>17</sup> Multivariate regression is one potential solution, but measurement issues and model specification invariably provoke debate. Instrumental variable regression is another potential answer, but finding valid instruments is typically very difficult (Greene and Gerber 2002: 809).

who receive each version of the question is sufficiently large, the differences in the responses should only be attributable to the small changes in the question wording.

Random assignment ensures that variables that may influence the responses are distributed roughly equally across each version of the question and thus should not be able to account for differences in responses between versions of the question. Survey-based experiments can alleviate the joint determination among public institutions, private institutions, and the propensity to trade by ensuring that public and private institutions do not co-vary. Moreover, survey-based experiments can provide greater confidence in making causal claims, in part because they require less stringent assumptions about the data than do standard survey analyses.<sup>18</sup>

## **Survey Description**

I commissioned a survey of 500 company managers in eight of Russia's 86 regions to address these and other questions.<sup>19</sup> At least one region from each of Russia's seven "super-regions" was included in the sample with most firms coming from the more heavily populated European part of Russia. The survey included firms from 23 different economic sectors as categorized by the State Statistical Agency and ranged from industrial giants in metals and energy to retail trading firms and light industry. The sample excluded firms in agriculture,

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<sup>18</sup> Survey-based experiments raise issues of internal and external validity. Concerns about internal validity arise "when the treatment does not exactly correspond to the construct that is envisioned as the independent variable" (Green and Gerber 2002: 811). Internally valid experiments capture the true causal process claimed by the researcher. External validity generates concerns about whether the results produced in an experiment travel outside the setting in which the experiment is conducted. To determine whether the experiments are valid, I also conduct an analysis that examines how reputation and courts influence the propensity to extend credit.

<sup>19</sup> The overall response rate was 55 percent for firms contacted by the interviewer. More than one-half of all refusals came from the capital city. Absent Moscow the response rate increases to 65 percent. The analyses are unchanged if responses from Moscow are dropped from the sample. Twenty percent of respondents were called back to ensure quality control. Respondents were asked a range of questions about the legal and business environment. Cities in the sample include Moscow, Nizhni Novgorod, Volgograd, Smolensk, Novgorod, Ekaterinburg, Voronezh, Rostov, Ufa,

communal services, and health and social services. Firms were chosen using a stratified random sampling technique. Researchers from the Levada Center stratified the sample by size and sector to mirror the population of firms in each region, and firms were selected at random from within each of the strata. Each firm within each stratum had an equal probability of being included in the sample.

Interviewers from the Levada Center spoke face-to-face with managers in the summer of 2008. Chief executive officers, chief financial officers, and chief legal officers were included as potential respondents, and interviewers spoke with only one person per firm. The distribution of firms in the sample roughly mirrors the national population. Most managers (70 percent) were male, and more than 90 percent had college-level degrees. The age of the average respondent was 47. The average (mean) firm included 436 workers and ranged from a minimum of 3 to a maximum of 22,000. Half the respondents headed firms with fewer than 130 workers, and one-quarter headed firms with fewer than 50 workers. Twelve percent of the firms were majority state-owned, and 62 percent had undergone some form of privatization. Levels of ownership concentration were fairly high. In 49 percent of the firms more than half of the shares were owned by a single stakeholder. Only five percent of firms had foreign ownership.

Focusing on reputation and courts in Russia is important, as business people rely heavily on both bilateral negotiations and courts to help resolve disputes. Sixty-nine percent of respondents who had had at least one dispute with a business partner in the last two years turned to a court to help resolve it.<sup>20</sup> Contrary to popular wisdom, courts are commonly used in Russia (see also Hendley et al. 2000; 2001). In addition, negotiations are common. Eighty-two percent

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Khabarovsk, Tula, and Omsk.

<sup>20</sup> Here courts refers to state arbitration courts which are the main formal fora for resolving economic disputes between informal actors and between informal and state actors. State arbitration courts are located in the capital city in almost every region in Russia.



of respondents who had at least one dispute engaged in negotiations with the other side. As reputation is an important element of negotiations there is much to be gained in studying the role of the former in the latter. Courts and negotiations are by far the most common means of resolving disputes in Russia and merit further examination.

### **Experiment One: The Value of Reputation**

To begin, I explored the value of a good reputation relative to a deep discount in sale price. In this experimental design, I created four slightly different versions of the question and randomly assigned respondents to questions. Half the managers were asked whether they would accept an offer to buy a good at a price 5 percent below the market price, and half were offered the same good at a 20 percent discount relative to the market price. In addition, half the managers were told that the seller had a good reputation and half were given no additional information about the reputation of the seller. This set-up allows us to compare the impact of a reputation for honesty relative to not having any information about the reputation of a trading partner. In addition, it permits comparison of the importance of reputation relative to a steep discount in price. More specifically we asked the following question:

## Experiment 1. Reputation and Price Discounts

Let's say that a firm with which you had not worked before offered to sell you a high quality product at a price [5/20] percent lower than the market price and asked for 50 percent prepayment.[XXX/In addition, this firm has a good reputation in the region in that it almost always fulfills its contractual obligations.]<sup>21</sup> Would your firm be willing to accept this offer?

- 1) Yes            2) Probably Yes            3) Probably no            4) No

Table One reports the percentage of respondents willing to accept the offer under the four experimental conditions. Here responses of yes and "probably yes" are reported.

**Table 1. The Value of Reputation**

	<b>No Information About Reputation</b>	<b>Good Reputation</b>
<b>5 percent discount</b>	63 (n = 117)	77 (n = 131)
<b>20 percent discount</b>	60 (n = 110)	83 (n = 145)

Percent responses answering "yes" or "probably yes." N = number of observations. Don't knows are counted as "no" responses when calculating the percentages.

Having a good reputation is a quite valuable asset. A seller with a good reputation can increase the percentage of buyers accepting her offer of a five percent discount to the market price by 14 percentage points compared to a similar offer made by a seller about whose reputation little is known (63 percent versus 77 percent). In addition, with a price 20 percent

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<sup>21</sup> Here XXX indicates that the respondent does not receive any information about the seller's reputation. To be clear, interviewers asked each respondent one of four different questions:

- 1) Let's say that a firm with which you had not worked before offered to sell you a high quality product at a price [5] percent lower than the market price and asked for 50 percent prepayment.
- 2) Let's say that a firm with which you had not worked before offered to sell you a high quality product at a price [5] percent lower than the market price and asked for 50 percent prepayment. **In addition, this firm has a good reputation in the region in that it almost always fulfills its contractual obligations.**
- 3) Let's say that a firm with which you had not worked before offered to sell you a high quality product at a price [20] percent lower than the market price and asked for 50 percent prepayment.
- 4) Let's say that a firm with which you had not worked before offered to sell you a high quality product at a price [20] percent lower than the market price and asked for 50 percent prepayment. **In addition this firm has a good reputation in the region in that it almost always fulfills its contractual obligations.**

lower than the market, a seller with a good reputation can increase the number of buyers accepting the offer by 23 percentage points (60 percent versus 83 percent).

It is interesting to note that when information about the reputation of the seller is not provided, reducing the price from 5 to 20 percent below the market does not lead to more acceptances of the offer. It seems that a discount of 20 percent to the market, if anything, produces skepticism about the credibility of the offer and reduces the likelihood that a buyer will accept. However, when the seller has a good reputation, a similar discount is associated with a 6 percentage point increase in the likelihood that the offer will be accepted.

Thus, having a good reputation is a more potent stimulus to trade than is a discount of 15 percent of the market price. In addition, price discounts have a larger impact when the seller has a good reputation. Finally, the fact that such a steep discount in price produces such a small change in the acceptance rate suggests that market relations in Russia still leave much to be desired.

## **Experiment Two: The Sources of Information about Reputation**

There is considerable agreement that reputation is an important factor in promoting trade in Russia and other developing economies, but less is known about how different sources of information about a reputation influence outcomes. To explore this issue, I conducted an experiment that manipulates whether the source of information about a firm's reputation is "the local press" or an "old business acquaintance." I also manipulated whether the information conveyed led the respondent to believe that the seller had either a good or a bad reputation for abiding by its contractual obligations. More directly, we asked the following question:

## Experiment 2. Gossip, the Press, and Reputation

Let's say that a company from another region with whom you had not worked before offered to sell you a product that you need for 10 percent less than the market price. Recently you learned [**in the local press/ from an old business acquaintance**] that the company had [**always/not always**] fulfilled its obligations to other firms in your region. Would your firm accept this offer?

- 1) Yes            2) Probably Yes            3) Probably No            4) No

The results from Table Two indicate somewhat surprisingly that “the local press” and “an old business acquaintance” are equally powerful sources of information about a firm's reputation. When the seller has a bad reputation and the source of information about the reputation is the local press, only 16 percent of respondents accepted the offer, but this figure was only 15 percent when the source of information is an old business acquaintance. Similarly, there are only minor differences in the acceptance rate when the seller has a good reputation (67 percent for the local press versus 69 percent for an old business acquaintance).

**Table 2. The Sources of Reputation**

	<b>Bad Reputation</b>	<b>Good Reputation</b>
<b>Local Press</b>	16 (n = 124)	67 (n = 120)
<b>Old Business Acquaintance</b>	15 (n = 131)	69 (n = 128)

Figures represent percent responses “yes” or “probably yes.” N = number of observations. Don't knows are counted as “no” responses when calculating the percentages.

Regardless of the source, sellers with a good reputation were far more likely to have their offer accepted than sellers with a bad reputation (67 percent versus 16 percent if the source is the local press, and 69 percent versus 15 percent if the source is an old business acquaintance). The impact of reputation here is much larger than in the preceding experiment reported in Table 1. This may be a reflection of the comparison group. In this experiment, the impact of a seller with

a good reputation is relative to a seller with a bad reputation, but in the preceding experiment the impact of a seller with good reputation is relative to a seller having no reputation. This suggests that the costs of having a bad reputation appear to outweigh the benefits of having a good reputation.

### **Experiment Three: Business Associations and Trade**

In this section, I explore the extent to which membership in a prominent business association can increase the propensity to trade. The focus here is slightly different than in preceding examples. If previous questions concerned features specific to firms, here reputation attaches to all members of the business association. In this manipulation, some respondents were told that the buyer is a member of the Russian Union of Industrialists and Entrepreneurs, (RUIE), the most prominent business association in Russia, while others received no information about the membership status of the buyer. In addition, respondents were told that the potential buyer was either from the respondent's region or from another region. Pyle (2006) argues that business associations are especially valuable in promoting trade across regions. To assess these arguments, we asked the following question:

#### Experiment 3. Business Associations and Trade

Let's say that a firm from [your/another] region is planning to place a larger order (about 20 percent of your annual sales) with your firm at the market price and offers to pay 50 percent up front and pay the rest two months after it receives the product. [XXXXXX/**The company is a member of the RUIE (the Russian Union of Entrepreneurs and Industrialists)**]. Would your firm be willing to accept this offer?

- 1) Yes            2) Probably Yes            3) Probably No            4) No

Table Three indicates that being a member of the RUIE significantly increases the likelihood that the respondent will accept the offer. If the buyer is from another region, being a

member of the RUIE increases the likelihood that the respondent will accept the offer by 16 percentage points (74 percent versus 58 percent). If the buyer is from the respondent's region this increase is 20 percentage points (71 percent versus 51 percent). This indicates that membership in the RUIE can play a signal role in promoting trade, whether the trading partner is from their own or another region. This result again illustrates the value of private solutions to the problem of trade in Russia.

**Table 3. The Benefits of Membership**

	<b>No information about membership</b>	<b>Member of RUIE</b>
<b>Another Region</b>	58 (n = 131)	74 (n = 120)
<b>Your Region</b>	51 (n = 126)	71 (n = 126)

Figures represent percent responses “yes” or “probably yes.” N = number of observations. Don't knows are counted as “no” responses when calculating the percentages.

It is somewhat surprising that respondents appear to prefer to trade with buyers from other regions rather than from their own region. One would expect that trading with a partner from a region other than your own would involve higher transaction costs and thereby depress incentives to engage in exchange, but that does not appear to be the case as in this experiment respondents, on average, preferred trading with buyers from another region rather than their own. The preference for trading with firms outside one's region is not especially pronounced (58 percent versus 51 percent when there is no information about a firms' membership status and 74 percent versus 71 percent when the buyer is a member of the RUIE), but this anomalous result merits further exploration.

## Experiment Four: The Impact of Reputation Relative to Courts

The last experiment compels respondents to make tradeoffs between using courts and reputation as a means of buttressing trade. This scenario allows us to examine the relative impact of courts and reputation in boosting trade between firms. Respondents were asked to evaluate the likely behavior of a manufacturing firm that has and has not been able to use courts in the past and that is considering an offer from a new firm. In one question, the manufacturing firm is told that the seller has a good reputation in the region, but in the other question, the manufacturing firm receives no information about the seller's reputation. We asked the following question:

### Experiment 4. Reputation, Courts, and Trade

Let's say that a firm in retail trade plans to place a big order at a large manufacturing plant in your region at a market price. This retail trading firm recently opened [XXXXXX], **but in the region it is considered to be a reliable partner.**]

What do you think: will the manufacturing firm accept this trade given than it has **[rarely/often]** been able to defend its interests in the state courts of arbitration?

- 1) It will refuse the offer.
- 2) It will accept the offer, but only the condition of a prepayment of \_\_\_\_\_ percent of the order. Please indicate the amount of prepayment: \_\_\_\_\_
- 3) It will accept the offer without any prepayment.

Table Four reports the results for each of the four scenarios. For example, when the respondent is given no information about the reputation of the buyer, and the seller is not expected to be able to use the courts, 22 percent of the respondents said that the manufacturer would refuse the offer outright; 24 percent said that the manufacturer would request at least 50 percent prepayment; and 53 percent said that the manufacturer would accept the trade without preconditions.

**Table 4. Reputation and Courts**

	<b>Refuse</b>	<b>Conditional Accept</b>	<b>Accept</b>
<b>No reputation Cannot use courts</b>	22	24	53
<b>No reputation Can use courts</b>	11	19	70
<b>Good reputation Cannot use courts</b>	18	23	55
<b>Good reputation Can use courts</b>	13	15	72

Percentage responses in each category. Demands for prepayment greater than 50 percent are treated as refusals and buyers are assumed to be much less likely to except this offer.

To make the results reported above easier to understand, I report the responses subtracting the refusals reported in Column 1 from the acceptances reported in Column 3 in Table 4. In Table 5, we see that buyers who are thought to be able to use courts are significantly more likely to accept the offer whether or not they have information about the seller's reputation. Indeed, the ability to use courts provides a powerful stimulus to trade. When the seller has no reputation, moving from a condition in which the buyer cannot use courts to one in which he can use courts increase the likelihood of accepting the offer from 31 percent to 59 percent. Similarly, when the seller has a good reputation, such a move increases the acceptance rate from 41 percent to 61 percent.

**Table 5. Balance of Those Accepting**

(Accept Offer-Refuse Offer)

	<b>Seller Cannot Use Courts</b>	<b>Seller Can Use Courts</b>
<b>Buyer has no reputation</b>	31 (n = 98)	59 (n = 103)
<b>Buyer has good reputation</b>	41 (n = 94)	61 (n = 109)

n = number of observations



In addition, reputation is an important promoter of trade especially when the buyer is thought to be unable to use courts. When the buyer cannot use courts, moving from a condition in which the seller has no reputation to having a good reputation increases the likelihood of acceptance by 10 percentage points (31 versus 41 percent.) This increase is smaller when the buyer can use courts (59 percent versus 61 percent). On balance, courts and reputation are complements. That is, having a good reputation is far more valuable when courts are also available to protect property rights.

### **Trade Credit and Reputation**

Survey experiments are a valuable tool for analyzing the impact of public and private institutions on trade, but here the questions have largely been hypothetical. Rather than reporting about their actual behavior, businesspeople have given responses about how they would act if they faced different circumstances. Because there is often slippage between how respondents say they would respond and their actual behavior, it is helpful to complement hypothetical questions with analyses of reported behavior as well. In the final section of this report, I examine whether businesspeople who rely on a good reputation when trading are more or less likely to extend credit to suppliers.

By reputation, I focus on respondents' expectations of how others will respond to news that a firm has violated a contract. More specifically, I aim to capture whether respondents expect others to punish firms that have a reputation for violating contracts. We asked this question: "What do you think other businesspeople in your region will do if they find out that a firm with which you are doing business violated its obligations?"

- 1) They will do nothing
- 2) They will change the terms on which they trade (e.g., most will ask for 100% prepayment)
- 3) They will gradually end the partnership
- 4) They will immediately end the partnership

Thirty-five percent of respondents said that upon learning of a contract violation others would do nothing; 43 percent of respondents said that others would change the terms of trade; 19 percent said that others would gradually end the partnership; and 3 percent said that others would immediately end trading relations with the firm. We also asked respondents whether or not they had given trade credits to a supplier. Examining the decision to give credit has important theoretical and practical implications (McMillan and Woodruff 1999; Johnson, Macmillan, and Woodruff 2002b). Whether or not firms give credit to other firms is a good indicator of confidence that their rights will be protected. The giver of credit suffers an up-front loss for the prospect of a greater return in the future and is vulnerable to violation of breach by the debtor. In addition, by promoting exchanges that otherwise would not take place, the creation of institutions to support the expansion of credit plays a critical role in economic development (North 1990; Greif 2004). Thirty-three percent of respondents said that they had given credit to a supplier in the past two years.

**Table 6. Reputation and Trade Credits**

<b>Others will ...</b>	<b>Percentage who gave credit to suppliers in the last two years</b>
<b>Do nothing</b>	<b>29</b> <b>N= 142</b>
<b>Change Terms (100% Prepayment)</b>	<b>41</b> <b>N = 174</b>
<b>Gradually/Immediately End Relationship</b>	<b>29</b> <b>N= 83</b>

These simple bivariate relationships results indicate that among those who expect others to do nothing upon hearing that a firm violated a contract, only 29 percent of respondents gave credit; among those who expect others to demand 100 percent prepayment, 42 percent gave credit to a supplier, a difference that is statistically significant; and among those who expected others to end the relationship either gradually or immediately, 29 percent gave credit. This indicates that the threat of changing the terms of a trading relationship by demanding 100 percent prepayment is associated with a much greater propensity to extend credits to suppliers. Those who expect others to value a reputation for fair trading are much more likely to give credit to suppliers.<sup>22</sup>

The positive relationship between expectations that other firms will change the terms of trading upon hearing of a violation and the extension of credit to suppliers also holds in more rigorous analyses. When controls for sector, region, the financial condition of the firm, and various personal characteristics of the respondent are included in a more sophisticated statistical analysis, those who expect others to change the terms of doing business with a disreputable firm are about 11 percentage points more likely to extend credit to suppliers than are respondents who expect other firms to do nothing upon learning of a violation. Because reputation provides a potent stimulus to trade in both the hypothetical experimental questions and in behavior reported in more traditional survey questions, we can have greater confidence in the results.

## **Policy Implications**

As noted in the introduction, determining whether private solutions to trade undermine or underpin public institutions has important implications for policy. If the former view is correct,

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<sup>22</sup> They are also more likely to extend credit to buyers.

then strategies to promote stronger property rights face difficult tradeoffs about supporting private or public institutions. If the latter is correct, then there exist important multiplier effects from strengthening either public or private solutions. This view generates a much stronger rationale for trying to improve the quality of public and private institutions. In addition, it is helpful to know the relative importance of these two different solutions to support trade. If a good reputation or strong courts provide little boost to trade, then one can question the value of devoting limited foreign aid resources to develop them.

The analysis presented above suggests that far from undermining public institutions, strong private institutions appear, if anything, to strengthen them.<sup>23</sup> That is, reputation is a more potent stimulus for trade when courts work well and vice versa, (although to a lesser extent). This suggests that the fear that private solutions to the problem of trade, such as networks of reputation, will undermine public institutions appears misplaced. Because public and private institutions appear to work better when the other is strong, efforts to strengthen one is likely to have significant spillover effects in also strengthening the other. This implies that efforts to create strong private and public institutions do not face a tradeoff and provides a justification for devoting foreign aid to rule of law reform efforts.

In addition, the findings suggest the importance of expanding rule of law reform efforts beyond a primary concentration on public institutions, such as courts, bailiffs, and legislators, to also include private institutions, such as networks of reputation, the local press, and business organizations, in efforts to build stronger property rights in Russia. Most attempts at legal reform focus on public institutions, such as training judges, re-writing legislation, and streamlining the court docket. Indeed, the terms rule of law reform and judicial reform are

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<sup>23</sup> Of course, identifying the best means of strengthening these institutions is an important question about which we know surprisingly little (Carothers 2006: 15-30).

almost used interchangeably.

This analysis, however, indicates that strengthening private solutions to the problem of trade is likely to have considerable impact on the security of property rights and should be an important component in promoting the rule of law. More particularly, it points to the importance of supporting the development of better business bureaus, credit rating agencies, business associations, and other institutional means of providing information about the past trading practices of firms. Market economies depend heavily on private institutions to complement public institutions in the goal of promoting trade between firms, but rule of law reform efforts have emphasized the latter and paid far less attention to the former. Correcting this imbalance should be an important part of future strategies for promoting the rule of law.

### **Caveats**

Several caveats to this analysis are worth noting. The analysis here refers only to a small subset of private solutions to the problem of trade including reputation, a free press, and business associations. Other types of private solutions, particularly those involving private enforcers or collusive arrangements between firms, likely have different consequences for the security of property rights. In addition, this analysis explores only disputes between run-of-the-mill firms and makes no claims that the findings relate to strategically important firms. Moreover, it focuses only on trading relations between firms and does not analyze other types of disputes such as those involving state officials. Nor does it examine disputes involving other types of transactions, such as disputes between private firms involving long-term investments. Finally, like all surveys, the data provide only a snapshot of a fairly dynamic environment.

## Conclusion

Scholars have developed a rich literature on the significance of public institutions, such as courts and bureaucracies for the creation of markets and states. They have also created an impressive body of scholarship on the role that private institutions, such as reputation and trust, play in these processes. However, we know less about the relative importance of public and private institutions and about how these institutions interact in different settings (but see c.f., Kohli and Shue eds. 1994). In addition, we know little about the relative importance of different sources of information about reputation and the magnitude of the value of having a good reputation.

These drawbacks are unfortunate, as the quality of institutions--both public and private--is a critical issue for transition and developing countries in general and Russia in particular. Evidence from a 2008 survey of businesspeople in Russia contributes to these debates. Analyses of survey responses indicate that private institutions, such as reputation, and public institutions, such as courts, both provide a potent stimulus to trade. In addition, both the local press and word of mouth are valuable sources of information about reputation. There is also evidence that good reputations and capable courts are complements rather than substitutes.<sup>24</sup>

Given the importance of reputation for promoting trade, future research would do well to analyze precisely how reputations travel. How do business elites gain information about contract violations if the disputes do not end up in court? Why are some business elites better informed about the reputations of potential trading partners than others? How do managers verify information about a particular dispute absent an impartial third-party arbiter? These are questions that merit greater attention.

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<sup>24</sup> That reputation and courts are mutually supporting is broadly consistent with Putnam (1994), but not Migdal (1988).

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