Taxes, Banking, and Legal Development in Russia: Lessons about Institutional Complementarities and the Rule of Law

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Abstract: A significant challenge faced by rule-of-law reformers is that newly created legal institutions frequently remain divorced from the de facto rules governing economic transactions. Firms instead rely on informal, and sometimes illegal, means of enforcing contracts, protecting property, and resolving disputes. This article proposes that one key to overcoming the chasm between formal legal institutions and on-the-ground practices is to adopt a broader understanding of legal development. In many cases, developments in spheres that are only indirectly related to formal legal institutions may be equally important, particularly if these developments either (1) increase the costs of illicit alternatives to reliance on law or (2) reduce barriers to firms’ use of formal legal institutions. This article illustrates the argument with two key examples in post-Soviet Russia: banking sector development and improved tax compliance.
Over the past three decades, a near consensus has emerged among legal scholars, social scientists, and policymakers regarding the importance of the rule of law—secure property rights, in particular—to stimulating and sustaining economic growth (see, for example, North 1981; Knack and Keefer 1995; Posner 1998; Acemoglu et al. 2001; Dam 2007). During this period, the international development community has dedicated vast sums of money to rule-of-law promotion, including nearly $3 billion in the 1990s and early 2000s from the World Bank alone (Trubek 2006, 74). Regimes that are not reliant on international aid or advice, including authoritarian regimes such as China and Singapore, have likewise recognized the significance of property rights, creating homegrown programs for promoting certain aspects the rule of law, particularly those needed to sustain economic relations (Peerenboom 2002; Rajah 2012). Yet despite colossal efforts, legal development projects have produced strikingly few success stories (Carothers 1998; Davis and Trebilcock 2008).

One significant challenge reformers face is that newly created legal institutions frequently remain divorced from the de facto rules governing economic transactions, particularly when institutions have been transplanted from abroad (Berkowitz et al. 2003). Firms instead rely on informal, and sometimes illegal, means of enforcing contracts, protecting property, and resolving disputes. In the most extreme cases, firms utilize the services of criminal protection rackets. In other cases, firms utilize illicit connections with state officials, a strategy that can corrupt formal legal institutions such as courts, law enforcement agencies, and specialized regulatory bodies.1

This article proposes that one key to overcoming the chasm between formal legal institutions and on-the-ground practices in many post-communist and developing countries is to adopt a broader understanding of legal development projects. Such projects usually focus on improvements to the judiciary, law enforcement agencies, the penal system, and the legal profession (see, for example, Carothers 1998; Daniels and Trebilcock 2004). These types of developments are undeniably critical for improving the effectiveness of legal institutions. But in many cases developments in spheres that are only indirectly related to formal legal institutions may be equally important, particularly if these reforms either (1) increase the costs of illicit alternatives to reliance on law or (2) reduce barriers to firms’ use of formal legal institutions. The two examples examined here concern

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1 Scholars have recognized the central role of informal practices in even the most developed economies since at least the seminal work of Macaulay (1963). But the illegal strategies addressed in this article differ from the informal strategies examined in the relational contracting and private ordering literature. Informal strategies such as reliance on informal norms, repeated interactions, or private arbitration coexist comfortably with formal institutions; illegal strategies involving violence or corruption do not.
banking sector development and improved tax compliance.\(^2\)

Banking sector development reduces firms’ reliance on cash transactions. As firms increasingly conduct transactions through banks, it becomes more complicated and expensive to maintain off-the-books cash, a critical component of many corrupt or illicit practices. Meanwhile, when firms are unwilling or unable to fulfill their tax obligations, they hesitate to use formal legal institutions out of fear that their own legal violations will be exposed. Improved tax compliance can therefore stimulate firms’ use of law.

To illustrate the relationships between banking sector development, tax compliance, firms’ use of formal legal institutions, and legal development more broadly, this article analyzes the case of post-Soviet Russia. Russia may seem like a surprising case for such analysis, particularly given many observers’ disproportionate attention to high-profile property rights disputes, usually involving major business tycoons and powerful state officials. Yet drawing on interviews with Russian firms, lawyers, and private security agencies, as well as an original survey of Russian enterprises, I demonstrate that following a turbulent decade in the 1990s, many of Russia’s understudied non-oligarchic firms reduced their reliance on criminal protection rackets or corrupt connections to state officials in favor of formal legal institutions. To be clear, this is not a claim that the rule of law—frequently defined as “a system in which laws are public knowledge, are clear in meaning, and apply equally to everyone” (Carothers 1998, 96)—has emerged in Russia. Though many run-of-the-mill court cases are conducted impartially, it is well-documented that in politicized cases, particularly high-profile cases in which powerful state actors have an interest, all are not equal before the law (Hendley 2009, 2011). Moreover, firms continue to face substantial threats to their property rights from predatory state officials (Gans-Morse 2012; Markus 2015).\(^3\) But the development of a more full-fledged rule of law clearly is infeasible when firms prefer to rely on private coercion or corruption rather than on law, leading everyday practices to diverge sharply from the formal rules of the game. The evolution of Russian firms’ strategies for enforcing contracts, protecting property, and resolving disputes is therefore significant and worthy of attention. Moreover, the fact that such evolution has occurred in an environment usually considered hostile to the rule of law indicates that insights drawn from the Russian case should be of value for a range of post-communist and developing countries. What works in Russia will

\(^2\) To be sure, tax administration reform often is included on lists of rule-of-law reforms, but the stated purpose of these reforms is to generate the revenue needed to build legal capacity, a complementary yet distinct goal from the issues discussed in this article (Daniels and Trebilcock 2004, 117).

\(^3\) It is also clear that Russian state officials regularly abuse the legal system to repress political opponents and civil society activists (Fish 2005; McFaul and Stoner-Weiss 2008).
arguably be even more effective in more benign environments.

In the Russian context, however, reformers did not intentionally or explicitly develop a strategy linking banking development, tax compliance, and law. The Russian government did make efforts to directly increase the state’s legal capacity, particularly in the early 2000s, including improved procedural codes, better funding of court administrations, and increased salaries for judges. But as argued elsewhere, these reform efforts were at best a partial success; neither improved legal institutions nor firms’ rising fear of the state’s coercive capacities can adequately account for Russian enterprises’ evolving reliance on law (Gans-Morse 2017a, 345-347; Gans-Morse 2017b, ch. 4). Moreover, to the extent that the state played a role in improved tax compliance or banking sector development, it was pursuing aims unrelated to the legal sector, such as revenue generation. Some policies in the sphere of taxation, such as overly aggressive auditing or the imprisonment of the oligarch Mikhail Khodorkovsky for tax evasion and other economic crimes, were arguably at odds with the development of the rule of law.

The critical point is not, therefore, that the Russian experience illustrates a successful reform plan or strategy, but rather that the Russian case offers intriguing evidence of the complementarities between the spheres of taxation, banking, and law. As discussed in the article’s concluding section, a focus on these complementarities may allow domestic reform coalitions and international agencies promoting the rule of law in other contexts to intentionally leverage these linkages across institutional spheres, particularly when direct reforms of the legal sector are technically infeasible or politically untenable.

The next section of this article provides an overview of the changes in Russian firms’ strategies for securing property. This is followed by analysis of banking sector development and the evolution of firms’ tax compliance in Russia, using qualitative analysis to trace the mechanisms through which changes in these institutional spheres encouraged firms’ use of law. Quantitative analyses are then employed to demonstrate the associations between tax compliance, reliance on cash transactions, and firms’ willingness to utilize formal legal institutions.

**Formal Institutions and Everyday Practices: Divergence and Convergence**

The Russian case illustrates both how on-the-ground practices can diverge from formal rules and how this emerging chasm can subsequently be bridged (at least to a significant extent). In the chaotic aftermath of the Soviet state’s collapse, the formal legal system—which had to be fundamentally retooled to serve a market rather than a socialist economy—was in
disarray. But institutional reforms proceeded quickly. By the 1990s, Russia had legislation in place on joint-stock companies, securities markets, and bankruptcy; a new Civil Code; and a new system of commercial courts. This institutional development drew praise from observers. Hendley (1997, 236), for example, concluded that “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.” Yet Hendley (1997, 246) also offered a strong caveat to this complimentary assessment, warning that Russia’s “excellent legal system on paper” was at risk of remaining “largely irrelevant for business” given firms’ reluctance to utilize the emerging system of courts. Pistor (1996, 87) drew similar conclusions about the unwillingness of firms to turn to formal legal institutions: “In Russia, the early institutional changes aimed at providing a court system for handling commercial disputes have so far proved to be largely ineffective. The main reasons for this appear to lie less in the inefficiency of the system than in the lack of demand for the services that it offers.” As a result, the formal rules and Russian firms’ everyday practices for enforcing contracts and protecting property diverged.

Instead of formal legal institutions, Russian firms during the early 1990s relied in part on informal practices—based on social norms, social networks, and repeated interactions—to avoid or resolve business disputes. These strategies comfortably coexist with, and may even complement, formal legal institutions in economies throughout the world (see discussion in Frye 2017, ch. 5). But firms also came to rely extensively on violence and corruption, which are much more likely to undermine the effectiveness of the formal legal system. Criminal protection rackets offered entrepreneurs protection against other criminals or unprincipled competitors, a service referred to as providing a “roof” (krysha), and frequently aided in contract enforcement, debt collection, vetting of business partners, and arbitration of business disputes (Skoblikov 2001; Volkov 2002). Estimates by Russian law enforcement suggested that in the early 1990s up to three-fourths of Russian businesses paid protection money (Webster 1997, 2–3). Such estimates are difficult to verify and should be treated with caution, but rigorous research conducted in the mid-to-late 1990s also found substantial evidence of criminal rackets’ influence, particularly among smaller firms. In a 1996 survey of 230 small retail shops in Moscow, Ulyanovsk, and Smolensk, Frye and Zhuravskaya (2000) reported that over 40 percent of respondents recounted having contact with a criminal group in the last six months, while Radaev’s (1999, 36–40) 1997 survey of 221 enterprises across 21 Russian regions found that approximately two in five respondents reported personally experiencing violent extortion or
threats of physical coercion “sometimes” or “often.” During this period, private security agencies also proliferated, offering similar services, many of dubious legality, to those provided by criminal rackets. Already by 1993 there existed approximately 5,000 officially registered private security agencies, and this figure grew to around 30,000 by the late 2000s (Volkov 2002, 138; Gans-Morse 2017b, 48). Larger firms created internal security services, which the journalist David Hoffman (1997) colorfully described as “private armies of security agents, bodyguards and commercial spies.”

In addition to criminal rackets and private security agencies, Russian firms in the 1990s turned to corrupt law enforcement officers and other state officials. Law enforcement protection rackets utilized their access to state resources for private gain, offering many of the same services as criminal protection rackets, including debt collection, contract enforcement, and adjudication of disputes. The services of rackets run by the Ministry of Internal Affairs (MVD) State Directorate for the Struggle with Organized Crime (GUBOP) and its regional branches (RUBOPs), as well as FSB (the KGB successor) units devoted to economic and organized crime, were in particularly high demand (Sborov 2003; Pravotorov 2006). But less powerful state actors also played an important role in the provision of security services, with some estimates indicating that approximately 30 percent of MVD personnel offered kryshas of various forms (Webster 1997, 30). By the late 1990s, firms were far more reliant on state officials, or on private security agencies with ties to the state, than on criminal rackets for protection services, with observers suggesting that criminal elements’ share of the private security market had fallen to under 20 percent (Khodorych 2002; Volkov 2002, 169–179; Sborov 2003; Taylor 2007, 45). Internal cables from the US Embassy in Moscow to the State Department in Washington summarized the shift as follows: “Moscow business owners understand that it is best to get protection from the MVD and FSB (rather than organized crime groups) since they not only have more guns, resources and power than criminal groups, but they are also protected by the law. For this reason, protection from criminal gangs is no longer so high in demand” (Chivers 2010).

There were, however, signs of significant changes in Russian firms’ practices for enforcing contracts and securing property by the late 1990s. Over time, these would allow for a degree of convergence between everyday conflict resolution practices and the formal rules governing economic transactions. In particular, substantial evidence points to a shift away from reliance on outright physical coercion. Matveeva’s (2007, 86) sociological

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4 Though illegal, some GUBOP leaders perceived these services not simply as a means of acquiring personal profit but as a necessary means of financing their units—including the purchase of cars, equipment, and subsidized meals for personnel—in the face of a state revenue crisis (Sborov 2003; Pravotorov 2006).
analysis of business conflicts in Russia’s Central Federal District identified a noteworthy decline in the number of businesspeople murdered in the course of conducting business on an annual basis, from 213 in 1997 to 33 in 2005. More broadly, journalists and Russian security experts reported a drop in contract killings by the early-to-mid-1990s. These sources additionally note that many of the contract killings that persisted into the 2000s were not the direct result of business conflicts but instead targeted journalists and human rights activists (Skvortsova 2000; Kommersant 2008; Krylov et al. 2008; Ram 2009). Survey and interview data also showed firms’ encounters with criminal rackets to be decreasing during this period. In contrast to the 40 percent of respondents who recounted having had recent contact with rackets in the 1996 survey conducted in Moscow, Ulyanovsk, and Smolensk by Frye and Zhuravskaya (2000), less than 25 percent of small shops in a 1998 survey conducted in the same three cities reported such encounters (Frye 2002). In line with these data, a co-founder of a prominent Moscow-based private security agency and former Ministry of Internal Affairs agent reported that by the mid-1990s “criminal groups were disappearing to such an extent that they were becoming simply something exotic.” Almost wistfully, he added that “If a client came to us and said that some bandity from the street had tried to extort him, well, this was for us something exciting. [It gave us a] sort of nostalgia for the old days” (Security 5, interview, 2009). These trends continued, and by 2010 the survey I conducted of 301 firms from eight Russian cities found that less than 8 percent of 105 small businesses in the sample (and less than 4 percent of the overall sample) reported contact with criminal protection rackets in the previous three years. Similarly, less than 5 percent of respondents said that they or their employees had “sometimes” or “often” been subjected to threats or physical coercion.

The shift away from violence was also evident in the private security sector. By the late 2000s, security agencies differed little from their Western counterparts, with experts estimating that provision of basic

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5 The survey was conducted in Moscow, St. Petersburg, Ekaterinburg, Nizhnyi Novgorod, Samara, Novosibirsk, Rostov-on-Don, and Kazan. The sample included both industrial and service firms and ranged in size from firms with under five employees to firms with nearly 10,000 employees. Additional details about the survey and qualitative interviews can be found in Sections 1.1 and 1.2 of the Online Appendix.

6 These comparisons of surveys over time should be interpreted with caution (see Frye 2010, 85–86). Later surveys may over-represent the views of firms that were least likely to face violence and protection rackets, and therefore more likely to avoid going out of business. It is also possible that firms over time became less willing to respond truthfully, biasing estimates of illicit activities’ prevalence downward. These concerns deserve acknowledgement, but it is unlikely that they account for the trends described here given the magnitude of the shift in assessments of violence and organized crime. The fact that in-depth interviews and analysis of objective indicators, such as murders of businesspeople and caseload statistics, corroborate the survey findings also bolsters the findings’ credibility.
physical security of buildings, cargo, and business executives accounted for 70 percent of the sector’s revenues, with the remainder consisting of information security, legal services, and the installation of cameras and alarms. As the security concerns of Russian businesspeople evolved, the notion of “economic security” (ekonomicheskaiia bezopasnost) came to be understood as responses to new and complex threats such as computer virus attacks by competitors or semi-legal raids utilizing complicated legal schemes to acquire assets. Firms specializing in economic security came to rely on lawyers, accountants, IT specialists, and former law enforcement officials rather than on violence and force to counter these emerging challenges. This is not to say that illicit practices were fully squeezed out of the private security market. Well into the 2000s, many security providers with ties to the state, or state officials themselves, continued to utilize state resources in questionable ways. My 2010 survey, for example, distinguished between the licit and illicit use of state coercion by asking respondents not only about the extent to which they relied on law enforcement agencies and state officials (e.g., inspectors, regulators, and other bureaucrats) but also whether they sought support from those officials in an official capacity or in an unofficial private capacity. Approximately 20 and 17 percent of firms reported using bureaucrats and law enforcement agencies, respectively, in an “unofficial capacity” to address a security issue in the previous three years. Yet despite the risk of these practices subverting state institutions, observers of the Russian business world often perceived them to be an improvement over the extraordinary violence of the 1990s. In the words of one Russian journalist, “the classic krysha is irreversibly becoming a thing of the past. These days, ‘protection’ of businesses appears to be more civilized” (Pravotorov 2006).

As violence was declining and security agencies and state officials were replacing criminal elements in the private security market, Russian firms also increasingly came to rely on formal legal institutions. The number of cases firms initiated in Russia’s commercial courts quintupled between 1994 and 2010, rising from around 200,000 to over a million (see Figure 1). Pioneering survey research by Hendley et al. (2000) found that reliance on the commercial courts was already increasing by the mid-

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7 Interview with Aleksandr Ivanchenko, Director of Russian Security Industry Association, June 8, 2009.
8 The survey used phrasing that was not directly incriminating yet was recognizable to Russian businesspeople as a reference to law enforcement protection rackets or similar types of corrupt services. Respondents were asked to clarify whether they used the resources of law enforcement or state officials in an “official capacity” (obratitsya kak k dolzhnostnym litsam) or “unofficial capacity” (obratitsya kak k chastnym litsam).
9 Russia’s commercial courts (arbitrazhnye sudy) are specialized courts within the state judicial system that hear civil disputes among firms and civil or administrative cases between firms and the state. Criminal cases are heard separately in the courts of general jurisdiction (sudy obshechei iurisdiktsii).
1990s, and a number of subsequent surveys showed that in the mid-2000s Russian firms utilized formal legal institutions extensively, with around one-third of smaller firms and two-thirds of larger firms reporting having had litigation experience (Johnson et al. 2002; Yakovlev et al. 2004, 69; Yakovlev 2008; Rimskii 2009, Table 2.1). Particularly noteworthy was firms’ growing willingness to use legal remedies even in disputes with state authorities, something that firms in many countries seek to avoid out of fear of retribution by state officials or due to a lack of faith that state-appointed judges will rule impartially in cases involving the state (see discussion
in Hendley 2002, 144-145). For example, between 2000 and 2008, cases against the tax authorities increased 280 percent. Litigation against state agencies in general represented nearly 20 percent of all cases initiated by firms by 2009, as can again be seen in Figure 1 (see also Trochev 2012).10

To be sure, rising caseloads can result from a growing number of disputes rather than increased willingness to turn to legal institutions, but survey data suggest this was not the case. Yakovlev (2008), for example, found that between 2000 and 2007, there was a decline in the extent of legal violations reported by firms. Meanwhile, in the 2010 survey I conducted, 54 percent of respondents reported that compared to 10 years earlier, they would be more willing or significantly more willing to turn to courts in response to violations of their legal rights; only 6 percent of respondents indicated that their willingness had declined. (Thirty-three percent of respondents said that their willingness to use the courts remained unchanged, and 7 percent were unsure.) Finally, a comparison of firms’ responses to the 1998 and 2008-2009 financial crises offers an additional indicator of firms’ increased willingness to use courts. As can be seen in Figure 1, inter-enterprise cases skyrocketed during the more recent crisis as firms flooded the court system with nonpayment disputes. There is no evidence of a similar rise in court usage during the 1998 crisis, suggesting that firms relied instead on extra-legal forms of dispute resolution.

Most business disputes, of course, do not end up in court, meaning that litigation rates attest to only a portion of the actual increase in reliance on lawyers and law (Hendley 2001). But many other indicators offer broader evidence that law has come to play an increasingly important role in the Russian business world. First, from the late 1990s through the 2000s the number of Russian lawyers increased, indicating a perceived demand for the profession (Hendley 2006, 364). The number of advokaty, the only lawyers in Russia for which a unified bar membership exists, more than doubled between 1996 and 2010, from 26,300 to 63,740.11 The growing role of lawyers can also be seen in the increased size of legal departments. In Hendley et al.’s survey conducted in 1997, legal departments ranged in size from 1 to 17 lawyers, with a mean of 2.5. The study further suggested that these legal departments remained largely unformed from the Soviet

10 Statistics in this paragraph are from the sources listed in the notes to Figure 1.
11 For biannual data from 1996–2004 on the number of registered advokaty, see Hendley (2006, 385). For more recent data, see Federalnaja palata advokatov [Federal Chamber of Lawyers] (2010, 32). Tracking the number of lawyers in Russia is difficult because the field of legal professionals is fractured among iuristy and advokaty, and only the latter are required to take a bar exam and pay bar membership dues. During Soviet times, advokaty were the rough equivalent of defense attorneys while iuriskonsulty were the rough equivalent of in-house counsel. In post-Soviet Russia, the distinction between the two is more ambiguous. Only advokaty can represent a client in a criminal case, but advokaty also serve corporate and business clients. For background on the structure of the Russian legal profession, see Hendley (2010, 8–9).
period, continuing to play a routine and insignificant role in Russian business practices (Hendley et al. 2001, 690, 693). In my 2010 survey, by contrast, firms reported much larger legal divisions—the size of legal departments in my survey ranged from 1 to 80 lawyers, with a mean of around 6—despite the average firm in my sample being smaller than in the Hendley et al. sample. Firms with dozens of in-house lawyers presumably consider legal resources to be valuable assets. Second, firms’ reliance on law beyond the state-provided court system can be seen in firms’ increasing use of private arbitration. Private arbitration in Russia does not directly involve state actors, but it functions in part because firms can turn to the commercial courts to enforce arbitration decisions. Although there is no unified source of data on private arbitration courts, data from individual courts suggest that demand for private arbitration—although still low—rose in the 2000s, particularly during the economic crisis of 2009. In some cases, this growth was significant: the Federal Court of Private Arbitration (Federalnyi treteiskii sud) heard 72 cases in 2008, 364 cases in 2009, and 956 cases in 2010 (Gans-Morse 2017b, 63). Meanwhile, the number of cases from private arbitration that were disputed or for which enforcement was sought via the official commercial court system cases increased sevenfold between 2002 and 2010, from 672 to 4,054, and then doubled to over 8,000 by 2015.

Third, interviews with lawyers point to notable changes in the legal profession and its role in business. As one of Russia’s top tax lawyers recalled, demand for his services skyrocketed in the late 2000s, whereas in the 1990s his “main problem was not winning, but convincing businesspeople that it was worth going to court” (Lawyer 21, interview, 2009). According to a prominent bankruptcy lawyer in Moscow, one of the reasons for this hesitancy was that “lawyers here are part of a very young profession. In the 1990s businesspeople thought of them as con-men (moshenniki).” Over time, he explained, the “image of lawyers more broadly has changed. They are like advisors now, not only for legal stuff but more generally in business” (Lawyer 3, interview, 2009). And when asked about the extent to which firms now use the court system, a lawyer from the Siberian town of Barnaul observed that “people have more or less

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12 The average legal department size reported above excludes four outliers whose representatives reported improbably large legal departments given the size of their firms. Three of these respondents classified their firms as part of the food and beverage sector. Interviews with insiders knowledgeable of this sector suggested that these firms are likely specialized service centers to whom Russian food and beverage companies outsource their legal and accounting services. Including these outliers increases the average size of legal departments in the sample to approximately 10. In terms of the comparability of the two samples, firm size in the Hendley et al. sample ranged from 30 to 17,000 employees, with a mean of 980 and median of 300. Firm size in my sample ranged from 3 to 9,000 employees, with a mean of 390 and median of 200.

13 These statistics are from the sources listed in the note to Figure 1.
come to resolve disputes in a civilized way, by going to court.” Indeed, he noted that the courts are so packed with litigants that “it is now impossible to move through the corridors of a courthouse” (Lawyer 22, interview, 2009).

A final source of evidence regarding the evolution of firms’ strategies for resolving disputes pertains to firms’ evaluation of their relative use of various strategies. Hendley et al.’s (2000, 635–636) study, based on a 1997 survey, found that even in the late 1990s firms considered courts to be relatively appealing compared to other approaches to resolving disputes. Other than direct enterprise-to-enterprise formal negotiations, turning to the courts was the most frequently used approach to addressing contractual problems with suppliers. Likewise, with the exception of stopping trade with a customer, litigation was the most common approach to dealing with customer conflicts. Yakovlev et al. (2004, 70) found similar results in a 2002 survey of open joint stock companies. For over half of the respondents, turning to the courts was their preferred method of dispute resolution.

My survey indicates that these trends toward reliance on formal legal institutions and law continued throughout the 2000s, as shown in Table 1. Respondents to the 2010 survey were asked to indicate, on a scale from 1 to 7, how likely a firm like theirs would be to utilize various strategies to resolve an asset dispute (with 7 representing “very likely” and 1 representing “very unlikely”). The highest-ranking strategies were the use of lawyers to resolve the conflict out of court (average ranking 6.0) and filing a claim in the commercial courts (5.7). These ranked higher than direct negotiations with the other firm’s management (5.3), even though negotiations are often considered to be the first step in resolving a conflict and were ranked at the top of firms’ preferred strategies in previous survey research (Hendley et al. 2000; Yakovlev et al. 2004). By contrast, the average rankings for the likelihood of turning to a private security firm or criminal protection racket were 2.3 and 1.9, respectively, while strategies involving the corrupt use of state resources ranked somewhere in between. Results were nearly identical for a similar question that examined firms’ preferred approaches to addressing a nonpayment conflict, as opposed to resolving an asset conflict.

Overall, data from surveys, interviews, caseloads, and other sources all offer evidence of a significant evolution in firms’ strategies for enforcing contracts, protecting property, and resolving disputes, with firms’ everyday practices converging with formal rules of the game over time as they came to utilize formal legal institutions. The following sections analyze how changes in the spheres of taxation and banking influenced these developments in the legal sphere. But before turning to this analysis, several issues deserve attention.
Taxes, Banking and Legal Development in Russia

Table 1. Russian Firms’ Preferred Responses to Nonpayment and Property Disputes

Respondents were asked the following questions:

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

Nonpayment Dispute: Let’s say that another company owes your firm a significant sum of money for products purchased or services rendered and has not made the payment, even though the agreed upon deadline has passed. To recover the money owed, how likely would a firm like yours be to use each of the following?

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

<table>
<thead>
<tr>
<th>Law and Formal Legal Institutions</th>
<th>Nonpayment</th>
<th>Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rely on lawyers to resolve the dispute out of court</td>
<td>6.31 (301, 0.07)</td>
<td>6.04 (297, 0.09)</td>
</tr>
<tr>
<td>Turn to the commercial courts</td>
<td>5.86 (292, 0.09)</td>
<td>5.69 (293, 0.10)</td>
</tr>
<tr>
<td>Seek the help of law enforcement officials acting in their formal capacity</td>
<td>4.83 (288, 0.13)</td>
<td>5.18 (290, 0.14)</td>
</tr>
<tr>
<td>Seek the help of government bureaucrats acting in their formal capacity</td>
<td>3.99 (294, 0.13)</td>
<td>4.57 (290, 0.12)</td>
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Informal Connections and Corruption

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<tr>
<th>Law and Formal Legal Institutions</th>
<th>Nonpayment</th>
<th>Property</th>
</tr>
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<tbody>
<tr>
<td>Turn to the commercial courts, using informal connections</td>
<td>4.19 (268, 0.14)</td>
<td>4.32 (268, 0.14)</td>
</tr>
<tr>
<td>Seek the help of law enforcement officials acting in an informal capacity</td>
<td>3.65 (288, 0.13)</td>
<td>3.78 (280, 0.13)</td>
</tr>
<tr>
<td>Seek the help of government bureaucrats acting in an informal capacity</td>
<td>3.37 (286, 0.13)</td>
<td>3.63 (291, 0.13)</td>
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Private Coercion

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<tr>
<th>Law and Formal Legal Institutions</th>
<th>Nonpayment</th>
<th>Property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rely on an internal security service</td>
<td>3.22 (274, 0.14)</td>
<td>3.29 (272, 0.14)</td>
</tr>
<tr>
<td>Seek the help of a private security agency</td>
<td>2.09 (270, 0.10)</td>
<td>2.21 (279, 0.11)</td>
</tr>
<tr>
<td>Seek the help of criminal or mafia groups</td>
<td>1.75 (277, 0.09)</td>
<td>1.87 (272, 0.10)</td>
</tr>
</tbody>
</table>

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

First, as in research on any sensitive topic, an important concern is whether the trends discussed above reflect social desirability bias or respondents’ imperfect recall. However, the similar findings from multiple sources and types of data—as well as the magnitude of the changes reported—suggest that these concerns should not be overstated. In addition, businesspeople may in general face incentives to underreport, rather than overreport, reliance on the legal system, given that classic studies such as Macaulay (1963) emphasize the ways in which litigation against business partners can be a breach of social norms. Second, a reasonable question concerns the extent to which Russia firms’ use of legal institutions reflects increased bribery and reliance on judicial corruption rather than law per se. Undeniably, illicit practices persisted throughout the 2000s,

14 See section 1.3 of the Online Appendix for further discussion of research on sensitive topics.
with nearly 14 percent of respondents to my 2010 survey admitting to the use of “informal connections” when turning to the commercial courts.  

But scholars such as Hendley (2006, 351) have found that the extent of illicit influence in Russian courts is limited: “mundane cases are handled in accordance with the prevailing law,” even if “cases that attract the interest of those in power can be manipulated to serve their interests.” Similarly, a partner at a Moscow law firm explained that “Connections are probably needed if the case is high-profile, big or political, or if the opponent is a large company. But for middle-sized cases they are not necessary . . . and the majority of cases are rather small . . . .” (Lawyer 6, interview, March 6, 2009). Third, it should be noted that the analysis above concerns non-oligarchic firms. Enterprises with connections to influential state officials and firms owned by powerful tycoons have consistently faced a different set of rules, many of which are based on the types of informal understandings analyzed by scholars such as Ledeneva (2013). Finally, it should be recognized that reversals of some of the trends discussed above may be underway, given the upheaval Russia has experienced in recent years due to slowing economic growth, geopolitical conflicts, and increasing confusion about the informal rules governing political and economic behavior among elites (see Barsukova 2019; Blyakher 2019). I return to these issues in the article’s concluding section.

**Taxes, Banking, and Legal Development**

Numerous factors affect Russian firms’ decisions about how to enforce contracts, protect property, and resolve disputes. In other works, I have developed a comprehensive explanatory framework (see Gans-Morse 2017a, 2017b), but the aim here is to more narrowly analyze the complementarities between legal development and changes in other institutional spheres, such as taxation and banking. The following sections examine each of these in turn. Qualitative analyses first trace the evolution of reliance on the formal banking system and tax compliance in post-Soviet Russia and establish the distinct mechanisms linking these to firms’ reliance on law. In particular, the analysis shows how firms’ declining use of cash transactions increased the costs of utilizing violence or corruption, making reliance on law more appealing, while increased tax compliance reduced barriers to firms’ use of formal legal institutions. Quantitative analyses then establish correlations between tax compliance, cash transactions, and firms’ choices of strategies for resolving disputes.

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15 Respondents were asked to distinguish between going to court fully in a “formal manner” (в формальном порядке) or going to court while also using “informal connections” (с использованием существующих там связей).
Banking and Reliance on Cash Transactions

The banking system that emerged following the collapse of the Soviet command economy was poorly equipped for financing and servicing a modern market economy. In the first years of transition, the number of banks skyrocketed, reaching more than 2,400 by 1994, far above the OECD average (OECD 2009, 99). But rather than serving as intermediaries between lenders and borrowers, most post-Soviet Russian banks instead functioned as corporate treasuries for financial industrial groups (FIGs) or other large companies, which in part used banks as a tool to move capital abroad or launder money. Despite the large number of banks, the system was highly consolidated, with approximately two-thirds of all banking assets belonging to just 30 banks in the late 1990s (Chowdhury 2003; Tompson 2004; OECD 2009, 99–100). Loans to enterprises without direct affiliations to banks, and particularly to smaller firms, were exceedingly rare, as can be seen in Table 2.

Not only did banks during the first post-Soviet decade fail to act as intermediaries between holders of capital and enterprises in need of financing, but they also rarely facilitated transactions. The Soviet payment system had been highly inefficient, posting payment orders by mail, but given money’s limited role in the command economy this had not been a significant impediment to Soviet enterprises’ transactions. This all changed with the emergence of a market economy. To make matters worse, banks often delayed the delivery of payments intentionally in order to profit from high inflation by holding the payment in a foreign currency (or other assets protected from rapid depreciation) before finally delivering the depreciated nominal payment, sometimes as late as several weeks after the transaction (Poser 1998, 168).

The absence of an effective banking system forced firms to rely on cash and barter transactions, a tendency exacerbated by firms’ efforts to hide transactions from tax authorities (discussed in greater detail below). At its high point, some estimates suggest that barter accounted for 50 percent of all transactions among industrial firms, and an even higher share of transactions conducted by larger firms (Tompson 1999, 259). Meanwhile, surveys found that between 25 and 30 percent of payments in the 1990s were conducted in “black cash”—off-the-books funds created through tax evasion schemes—with this cash economy especially prevalent among smaller firms (Yakovlev 2001, 47).

The 1998 financial crisis dramatically transformed the Russian financial system. More than one-third of bank assets were tied up in claims on government debt, and most of these assets were lost when the state defaulted. Meanwhile, a fifth of liabilities were held in foreign denominations that were significantly inflated following Russia’s currency
devaluation. As a result, many financial institutions were unable to survive the crisis, accelerating the process of banking sector consolidation that was already underway (Barisitz 2009, 48). This consolidation, combined with unexpected economic growth in the wake of the crisis—the result first of a rise in import-substitution manufacturing and later of rising oil prices—bolstered the financial sector. By the early 2000s, capital-starved firms were seeking loans in order to maintain their rapid pace of expansion. At the same time, whereas pre-crisis banks had thrived on speculative activity based on hyperinflation, short-term bonds, and privatization auctions, these opportunities dried up following the crisis, forcing banks to turn their attention to non-speculative operations. A series of banking reforms conducted between 2003 and 2005 further contributed to the sector’s development. The government created deposit insurance, increased the capital adequacy ratio and minimum capital requirements, mandated a transition to the International Accounting Standard, developed a simplified lending system for small businesses, and amended the Law on Banks and Banking Activity and the Law on the Bank of Russia so as to improve the regulatory environment (Chowdury 2003; Tompson 2004; Barisitz 2009, 52–53).

Table 2. Loans, Deposits, and Bank Transactions, 1999-2008

<table>
<thead>
<tr>
<th>Credits extended to non-financial enterprises (% of GDP)</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposits by non-financial enterprises (% of GDP)</td>
<td>1.3</td>
<td>1.6</td>
<td>2.4</td>
<td>2.3</td>
<td>2.1</td>
<td>1.8</td>
<td>2.6</td>
<td>3.5</td>
<td>4.7</td>
<td>8.5</td>
</tr>
<tr>
<td>Number of transactions conducted through the Russian payment system (millions)</td>
<td>--</td>
<td>--</td>
<td>63</td>
<td>738</td>
<td>855</td>
<td>992</td>
<td>1117</td>
<td>1673</td>
<td>2456</td>
<td>2782</td>
</tr>
</tbody>
</table>


As can be seen in Table 2, Russian firms recognized the growing stability and trustworthiness of the banking system and began to make bank transactions, deposit funds, and seek bank loans. Credits to non-financial enterprises as a percentage of GDP approximately doubled between 1999 and 2005; deposits as a percentage of GDP increased nearly eightfold from the end of the 1990s through the 2008-2009 recession. In the early 2000s the government also took steps to reduce tax evasion, requiring all companies to open bank accounts and mandating that all large transactions be conducted through the banking system (Yakovlev 2001, 47). As transactions through the formal financial system became more common, firms
began to perceive unwillingness to conduct business via bank transactions as a sign of unscrupulousness. According to a consultant who specializes in investment in Russia’s regions, “[Firms use] only bank transactions—there is now practically no cash used. Well, comparably little is still used. [It is used] for the illicit activities that are still conducted (v gryaznie veshchi kotorye ostalis)” (Firm 15, interview, 2009). Concerns raised by firms’ avoidance of the banking system increasingly led to wariness on the part of potential business partners, providing further incentives to utilize the banking system (Firm 1, interview, 2009).

As firms became more reliant on the banking system, they became less willing to employ violence or utilize corruption due to the rising costs of undertaking illicit activities and the greater probability that such practices would be exposed. When firms were conducting nearly all transactions in cash, it was relatively easy to allocate resources to bribe government officials or pay criminal protection rackets. By contrast, when transactions are done through the banking system, they leave a paper trail. It is possible to conceal this trail through front companies, slush funds, and other related schemes, but this entails additional time, expense, and risk of getting caught (Firm 1, interview, 2009).

Additionally, the increased role of the banking system created a new layer of vetting and screening. For example, a manager at a mail-order business based in Moscow related an incident where a representative of his company who had been sent to open a bank account appeared to be concealing information, leading to a denial of his request. Within a short span of time, the firm found itself on a blacklist that complicated its opening of bank accounts throughout Moscow until the matter had been resolved (Firm 9, interview, 2009). The possibility that an unsavory reputation could reduce firms’ access to the banking system served as yet another deterrent to engagement in illicit practices.

In summary, the switch from cash to bank transactions reduced firms’ access to off-the-books cash, which forced firms engaged in illegal activity to develop creative schemes to hide the paper trail that bank transactions leave behind. As a result, the transaction costs of illicit practices for enforcing contracts or protecting property multiplied. Meanwhile, the vetting undertaken by banks before firms could receive loans or open bank accounts increased the risks associated with illegal activity. Together, these changes contributed to the shift from violence and corruption to reliance on law discussed in the preceding section.

**Tax Compliance**

While firms’ decreased use of cash transactions created incentives to reduce reliance on illicit activities, firms’ rising tax compliance had a
complementary effect by removing barriers to firms’ use of formal legal institutions. In the wake of the Soviet Union’s collapse, a large informal economy had emerged, due in part to firms’ tax avoidance. Tax compliance had little meaning in the Soviet command economy, in which the state owned all productive assets and taxation was a means of resource allocation among enterprises and ministries rather than a tool for extracting revenue from private firms. Consequently, the concept of paying taxes was foreign to Russia’s emerging entrepreneurs, while the tax administration was underdeveloped and dependent on a narrow tax base consisting of large, recently privatized firms and the remaining state-owned enterprises (Easter 2002). The Yeltsin administration’s decision to grant regional governments the right to implement new taxes further complicated tax payment, leading to over 200 different taxes by the late 1990s, many of them implemented at the subnational level, and an aggregate tax rate nearly equivalent to 100 percent of enterprise profits (Himes and Milliet-Einbinder 1999, 170; Shleifer and Treisman 2001, 95-97, 118). In response, firms turned to schemes such as barter and underreporting of sales or wages to alleviate their tax burden (Shleifer and Treisman 2001; Yakovlev 2001).

Legal scholars quickly recognized how low levels of tax compliance could limit firms’ willingness to utilize formal legal institutions. Solomon (1997, 54), for instance, noted that “The realities of the tax system and the ways that many firms chose to cope with it (operating partly in the gray economy with two sets of financial records) had the added effect of discouraging those firms from using the courts to resolve disputes” because firms were “loathe to risk exposing their own illegal practices.” Pistor (1996, 85) offered nuanced detail of why tax violators hesitated to utilize courts, explaining that “Even where the courts themselves do not inquire into the nature of a transaction, there is a clear danger that cases will come to the attention of other state agencies, such as the Procuracy . . . [which] still enjoys broad powers to oversee the observance of legality...Tax authorities are also likely to keep an eye on any documentation revealing the volume of transactions or profits of a company.” Moreover, counterparties in a legal dispute were likely to take advantage of evidence of tax evasion, such as suspicious bookkeeping. As one Moscow lawyer explained, there is “always the risk that somebody who knows about [a company’s] ‘sins’ may whisper [to] the tax authorities,” thereby turning tax violations into “a weapon that can be used against the company” (Lawyer 8, interview, 2014).

Just as Russia’s 1998 financial crisis significantly affected the banking system, it also dramatically altered firms’ calculus regarding the costs and benefits of exiting the informal sector. Unexpected economic growth in the year following the crisis encouraged firms seeking to exploit emerging economic opportunities to formalize their operations (Dyufi
The crisis also engendered a sense of mutual vulnerability among business tycoons and Russia’s leaders, resulting in a cooperative policymaking effort that produced long-needed tax reforms (Jones Luong and Weinthal 2004). These in turn further encouraged tax compliance by formalizing taxpayers’ rights and obligations, streamlining tax collection for social funds, and reducing tax rates (Anisimova et al. 2008a, 2008b).

From a peak of nearly 10 percent of GDP in 1998, tax arrears dropped sharply, with arrears to the consolidated state budget falling to around 5 percent of GDP by 2001 and nearly disappearing by the late 2000s (Gans-Morse 2017b, 101). In part, the fall in arrears resulted from the growing economy, but improved tax compliance also played an important role. According to the Business Environment and Enterprise Performance Surveys (BEEPS) conducted by the World Bank and European Bank for Reconstruction and Development, the percentage of respondents claiming that typical Russian firms report 90 percent or more of sales revenue for tax purposes rose from 42 percent in 1999 to 65 percent in 2005, a 23-percent-age-point increase. The magnitude of change was even larger for the percentage of respondents claiming that typical firms report 100 percent of revenue, a 32-percentage-point increase (from 28 to 60 percent). 16

These surveys are not panel data, and so some caution is required in interpreting these changes. Moreover, tax avoidance clearly remained a problem well into the 2000s, given that 35 percent of respondents in 2005 still indicated that a typical Russian firm reported less than 90 percent of sales revenues. Nevertheless, the magnitude of the reported change is striking, and interview evidence attests to the dramatic effect of improved tax compliance on removing barriers to firms’ use of formal legal institutions.

A founding partner of a Moscow law firm explained, for example, that “There are [now] more commercial disputes between legal entities. That is, companies have switched, well, are switching, to a legal tax regime system. Accordingly, they turn to law firms, conclude civil contracts, and find protection for their contracts in the courts. Previously, everything was decided with a handshake . . . Now it’s not like this” (Lawyer 20, interview, 2009). Similarly, discussing firms’ ability to address concerns about employee theft, a prominent issue in Russia in the 2000s, another respondent emphasized that firms “have to operate legally (byt belymi), because when they catch a dishonest accountant in the act of stealing, they explain: ‘Listen, man, I pay my taxes . . . so let’s go to court.’ And they will not be afraid to go to court, because they know that their books are clean” (Firm 15, interview, 2009). In summary, Russian firms’ avoidance

16 Author’s calculations based on data from the BEEPS surveys. Difference-in-means tests show that all differences between the 1999 and 2005 averages are statistically significant at the 1 percent level.
of taxes created a barrier to their use of formal legal institutions in the 1990s. Changes in the Russian economy and improvements in Russia’s tax administration facilitated tax compliance, removing this barrier and contributing to firms’ increased reliance on law.

Quantitative Analyses

Survey data provide further evidence of the relationships between tax compliance, reliance on cash transactions, and firms’ utilization of violence, corruption or law to resolve disputes. Ideally, panel data would allow for the tracking of individual firms over time, facilitating analysis of how changes in a firm’s tax compliance or use of the formal banking system affect its strategies. Longitudinal datasets measuring the relevant variables unfortunately do not exist, but it is nonetheless feasible to cautiously draw inferences from the cross-sectional data. If paying taxes reduces barriers to firms’ use of formal legal institutions, then firms that are more tax-compliant should be more likely to use legal institutions and less likely to rely on violence or corruption. Similarly, if cash transactions are critical for engaging in illicit strategies, then firms that rely less on cash transactions should find such practices relatively more costly and be less likely to utilize private coercion or illicit connections to state officials.

To this end, firms in the survey I conducted were asked “Approximately what percentage of total annual sales would you estimate the typical firm in your line of business reports for tax purposes?” Sixty-eight percent of those responding stated that a typical firm reports more than 90 percent of sales revenues. Similarly, respondents were asked, “Approximately what percentage of your firms’ transactions are conducted in cash?” Fifty percent of those responding reported that they conduct less than 10 percent of transactions in cash, while the other half of the sample reported using cash in more than 10 percent of transactions.17

I then reconsidered firms’ preferred approaches to responding to the hypothetical property and nonpayment disputes introduced in Table 1, in

17 For both the tax compliance and cash transaction question, respondents were given six choices: less than 10%, 10 to 24%, 25 to 49%, 50 to 74%, 75 to 89%, or more than 90%, as well as “not sure/unwilling to answer.” In the analyses that follow, I use dichotomous to facilitate interpretation. Results are similar when a threshold of 75 percent of sales reported to tax authorities is used for the tax variable instead of a 90 percent threshold and when a threshold of 25 percent of transactions conducted in cash is used for the cash variable instead of a 10 percent threshold. It should also be noted that both of these variables exhibit high levels of non-response, possibly due to the sensitive nature of the questions. Non-responses are presumably positively correlated with lower tax compliance and higher reliance on cash, meaning that the statistics above most likely overestimate tax compliance and underestimate cash transactions. For the regression analyses, I mitigate concerns associated with missing data by employing multiple imputation using the AMELIA II package for R (Honaker et al. 2011) (see Section 2.1 of the Online Appendix for additional details). Results are robust to the use of listwise deletion.
Table 3. Tax Compliance, Cash Transactions, and Firms’ Responses to Property Conflicts (OLS Regressions)

Dependent variables are firms’ evaluations of their likelihood of using various strategies for responding to a property dispute on a 1 to 7 scale where 1 is “very unlikely” and 7 is “very likely” (see Table 1 for additional details). Coefficients for the Tax Complier variable represent the difference between the average responses of firms that report more than 90 percent of sales revenue for tax purposes and firms that report less than 90 percent, holding other factors constant. Coefficients for the Low Cash variable represent the difference between the average responses of firms that conduct less than 10 percent of transactions in cash and firms that conduct more than 10 percent, again holding other factors constant.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>p-value</th>
<th>Controls</th>
<th>Observations</th>
<th>R-sq.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Private Coercion</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Complier</td>
<td>-0.84**</td>
<td>(0.26)</td>
<td>&lt;0.001</td>
<td>yes</td>
<td>301</td>
<td>0.33</td>
</tr>
<tr>
<td>Low Cash</td>
<td>-0.30</td>
<td>(0.24)</td>
<td>0.002</td>
<td>yes</td>
<td>301</td>
<td>0.34</td>
</tr>
<tr>
<td>B. Informal Connections and Corruption</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Complier</td>
<td>-0.70*</td>
<td>(0.34)</td>
<td>0.007</td>
<td>yes</td>
<td>301</td>
<td>0.24</td>
</tr>
<tr>
<td>Low Cash</td>
<td>-0.78*</td>
<td>(0.34)</td>
<td>0.007</td>
<td>yes</td>
<td>301</td>
<td>0.24</td>
</tr>
<tr>
<td>C. Law and Formal Legal Institutions</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax Complier</td>
<td>0.45</td>
<td>(0.24)</td>
<td>0.001</td>
<td>yes</td>
<td>301</td>
<td>0.46</td>
</tr>
<tr>
<td>Low Cash</td>
<td>0.03</td>
<td>(0.23)</td>
<td>0.10</td>
<td>yes</td>
<td>301</td>
<td>0.05</td>
</tr>
</tbody>
</table>

Note: Robust standard errors in parentheses. **p < 0.001, *p < 0.01, *p < 0.05, †p < 0.10. Control variables include firm’s age, number of employees, financial health, sector, city of location, and ownership structure (i.e., whether or not the firm has foreign or government shareholders); the respondent’s age, gender, job description, and education; and dummy variables for recent disputes and litigation experience. Missing data have been multiply imputed using the AMELIA II package for R (Honaker et al. 2011). Analyses for turning to government officials in their official capacity are not shown due to space constraints. Full regression tables are provided in Section 2.3 of the Online Appendix.
the respondent’s firm has recently been involved in disputes or litigation. Summary statistics for all control variables are provided in Section 2.2 of the Online Appendix.

Coefficients on the Tax Complier variable represent the difference between the average responses of firms reporting more than 90 percent of sales revenue for tax purposes and firms reporting less than 90 percent, while coefficients on the Low Cash variable represent the difference between the average responses of firms conducting less than 10 percent of transactions in cash and firms conducting more than 10 percent, holding other factors constant. In accordance with the claim that tax-paying firms and firms that rely less on cash transactions are less likely to utilize private coercion, all coefficients in Panel A in Tables 3 and 4 are negative. Most notably, tax-paying firms rate their likeliness of turning to criminal rackets to resolve a property dispute more than 0.8 points lower than those that do not pay their taxes, and they are approximately 0.7 points less likely to use rackets to resolve a nonpayment dispute, results that are statistically significant at the 1 percent level. Firms that rely less on cash transactions rate their likelihood of employing rackets to resolve a property dispute 0.3 points lower, and of resolving a nonpayment dispute nearly 0.5 points lower, although only the latter is statistically significant.

Results are most robust for responses involving the illicit use of state resources, as shown in Panel B of Tables 3 and 4. Both tax-paying firms and low-cash firms rate their likelihood of turning to courts while using informal connections and seeking the help of law enforcement or other state officials in an unofficial capacity between 0.6 and 1.3 points lower than firms with lower tax compliance and higher reliance on cash transactions. All results in Panel B in both tables are statistically significant at least at the 10 percent level, and in many analyses at the 5 percent, 1 percent or 0.1 percent level.

Finally, in line with the above analysis about how tax compliance removes barriers to firms’ use of formal legal institutions, Panel C shows that firms reporting more than 90 percent of sales for tax purposes rate their likelihood of turning to courts (without reliance on informal connections) to resolve property or nonpayment disputes around 0.6 points higher than firms with lower levels of tax compliance, a result that is statistically significant at the 5 percent level. Tax compliers also express more willingness to use lawyers to resolve property disputes—though not nonpayment disputes—out of court. Reliance on cash transactions is not correlated with propensity to utilize lawyers and courts, but this is not entirely surprising given that, as discussed above, the reduced reliance on cash transactions most directly affects firms’ costs of employing illicit practices.

Although the cross-sectional nature of these analyses limits what can be inferred, particularly with respect to the direction of causality, the
results are consistent with the qualitative evidence from the preceding section demonstrating how firms’ evolving practices for resolving business disputes resulted from improved tax compliance and reduced reliance on cash transactions. More broadly, the quantitative analyses clearly establish the complementary nature of taxation, banking-sector, and legal development. The final section turns to the broader implications of these findings.

Table 4. Tax Compliance, Cash Transactions, and Firms’ Responses to Nonpayment Conflicts (OLS Regressions)

Dependent variables are firms’ evaluations of their likeliness of using various strategies for responding to a nonpayment dispute on a 1 to 7 scale where 1 is “very unlikely” and 7 is “very likely” (see Table 1 for additional details). Coefficients for the Tax Complier variable represent the difference between the average responses of firms that report more than 90 percent of sales revenue for tax purposes and firms that report less than 90 percent, holding other factors constant. Coefficients for the Low Cash variable represent the difference between the average responses of firms that conduct less than 10 percent of transactions in cash and firms that conduct more than 10 percent, again holding other factors constant.

Note: Robust standard errors in parentheses. \*\*\* p < 0.001, \*\* p < 0.01, \* p < 0.05, \( p < 0.1 \). Control variables include firm’s age, number of employees, financial health, sector, city of location, and ownership structure (i.e., whether or not the firm has foreign or government shareholders); the respondent’s age, gender, job description, and education; and dummy variables for recent disputes and litigation experience. Missing data have been multiply imputed using the AMELIA II package for R (Honaker et al. 2011). Analyses for turning to government officials in their official capacity are not shown due to space constraints. Full regression tables are provided in Section 2.3 of the Online Appendix.

Discussion

This article has offered evidence of a significant divergence between Russian firms’ everyday practices for enforcing contracts, securing
property, and resolving disputes and the rules of the game envisioned when formal legal institutions were created in the early 1990s. But over time, de facto practices converged to a significant extent as firms turned away from violence and corruption and increased their reliance on law. Development of the banking sector and rising tax compliance contributed to this shift. The former raised the transaction costs of illicit practices, while the latter reduced the barriers to the use of formal legal institutions faced by tax-avoiding firms.

Whether the convergence of on-the-ground practices and formal rules of the game will continue remains to be seen. Since Russia’s 2014 annexation of Crimea, the Russian economy has been buffeted by international sanctions. Low oil prices have also exacerbated Russia’s economic hardships. By some accounts, Russian firms, particularly in regions such as the Far East, have responded to these challenges by again moving operations into the informal economy, both to cut costs and to avoid extortion by predatory state officials (Blyakher 2019). Additionally, in recent years, state-owned enterprises have proliferated, shrinking the private sector’s relative share of the economy (Meriminskaya 2016). If such trends persist, it is possible that barriers to firms’ reliance on formal legal institutions will reemerge.

But from a broader perspective, the complementarities between taxation, banking, and legal development examined here offer lessons for rule-of-law reformers in other contexts. The developments traced in this article, to be sure, were not the result of a blueprint by Russian reformers or international agencies. The 1998 financial crisis, for example, played an unexpectedly beneficial role, transforming Russian firms’ practices in ways few analysts or policymakers could have foreseen. Yet the analysis here suggests that in other settings, reformers should consider the ways in which promoting banking-sector development and improving tax compliance can contribute to legal development. Reforms focused directly on improving the effectiveness of the judiciary, law enforcement agencies, the penal system, and the legal profession are undoubtedly of great importance, but their effects will be limited if firms face strong incentives to avoid formal legal institutions. Moreover, for international agencies seeking to support legal development, efforts to directly influence legal systems may prove politically sensitive. By contrast, a focus on tax administration reform that facilitates tax compliance has the added political benefit of increasing state revenues, while a focus on banking sector development may be politically palatable if packaged as a means of stimulating economic growth.

The convergence of everyday actors’ de facto practices and the formal rules governing economic transactions is, of course, not equivalent to the establishment of the rule of law. But it is an important prerequisite to the type of legal development often envisioned by rule-of-law reformers.
Thinking more holistically about legal development may allow reformers to leverage linkages across institutional spheres, thereby making formal legal institutions more accessible to individuals and firms, as well as more appealing compared to extralegal alternatives.

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