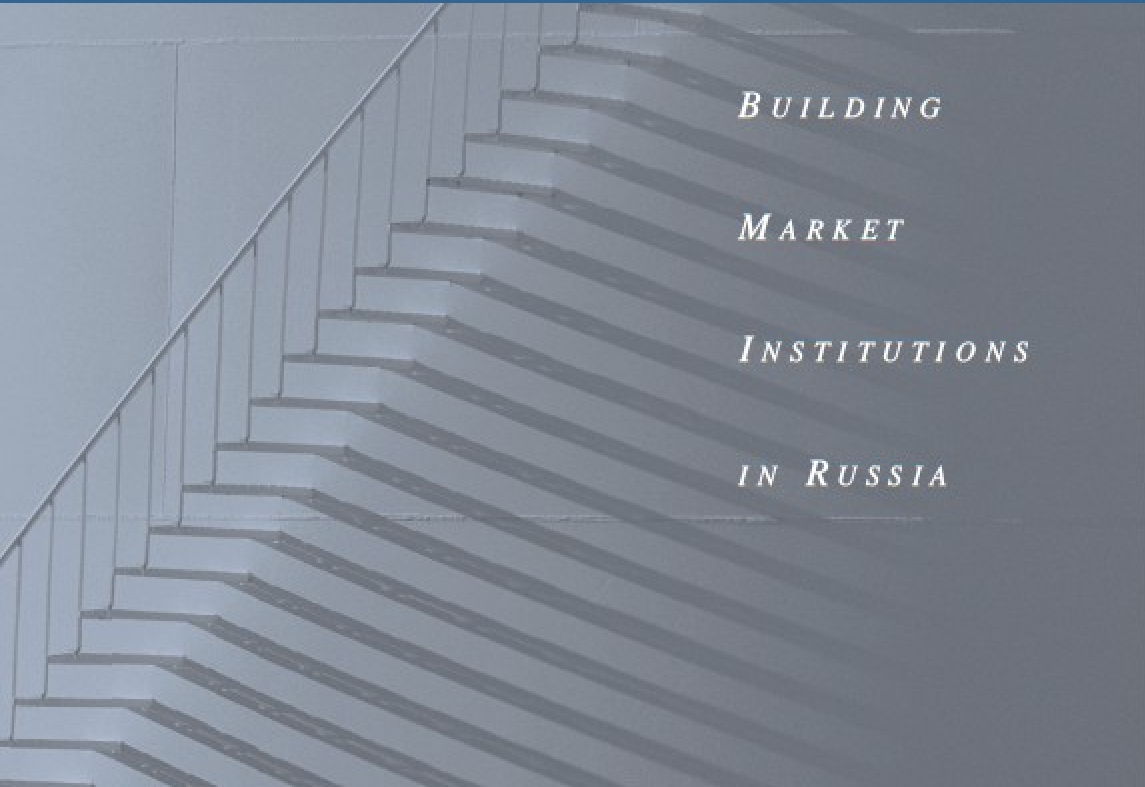
TIMOTHY FRYE

Brokers and Bureaucrats



BUILDING MARKET INSTITUTIONS IN RUSSIA

MICHIGAN

Brokers and Bureaucrats

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Building Market Institutions in Russia

Timothy Frye

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Preface

Creating institutions to support a stable social order is a findamental problem that has concerned philosophers and social scientists for centuries. Absent reliable third-party enforcement by the state, individual incentives to cheat on agreements are too tempting to ignore and lead to perverse results for society. This problem of social order prompts the main question of the book: Under what conditions can private groups govern themselves without turning to the state for enforcement?

This work examines the problem of social order on the micro level in postcommunist Russia. Many have documented Russia's attempt to create a stable social order, but few have analyzed a prior issue: the ability of the Russian state—or any other organization—to create institutions that provide public goods that make social order possible. We typically view the state as an organization that has a monopoly on the legitimate use of force over a given territory, but the Russian state exercises only a tenuous claim to this monopoly. In response to the weakness of the Russian state, brokers and bureaucrats in postcommunist Russia have sought to build institutions between the state and the market that allow businesspeople to trade with some confidence that contracts will be honored. This work seeks to explain why some efforts to create institutions to support self-governance and create social order on markets in Russia succeeded, while others failed. It develops a political theory of self-governance to account for this puzzle.

Institutions are central to economic growth, democratic governance and the creation of a stable social order. Despite the importance of institutions, we still have much to learn about their creation and performance. This work aims to enrich our understanding of this important topic.

Throughout the book I use the Library of Congress system of transliteration from English into Russian. I bow to convention for words that already have a standard English-language version, such as *Yeltsin* or *Yakovlev*. Unless otherwise stated, the Russian translations are my own.

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Introduction

The Problem of Social Order

In the summer of 1993 I asked a broker on a commodity exchange in Moscow how he knew when someone was planning to cheat him. "Well, before we sign the contract, I look him straight in the eye, and if he blinks, then I know he is going to cheat me," he said. Puzzled, I asked him if this method ever worked. "Not usually," he responded, "but I don't have anything else to go on." Perhaps it is not surprising that brokers working in this market regularly violated contracts and commonly turned to big men with big guns to protect their property rights.

In the summer of 1995 I asked a broker on the Russian equities market the same question. "Cheating on contracts is not a problem," he said. "Brokers are worried that others will see them as dishonest so they do what they can to fulfill their contracts. This market works by—how do you say in English—by 'word of mouth.'" Word of mouth seemed to work quite well on this market. Brokers rarely violated contracts with one another, and the Russian equities market was the best performer in the world in 1996 and 1997.[1]

These anecdotes illustrate a classic problem of social order that has concerned philosophers and social scientists at least since Hobbes: in the absence of reliable third-party enforcement, individual incentives to cheat on agreements are too tempting to ignore and lead to perverse results for society. This problem of social order prompts the main question of this book: Under what conditions can private groups govern themselves without turning to an outside agent for enforcement? Here *self-governance* means that group members write rules, resolve disputes, and levy sanctions without relying on an external enforcer, such as the state or organized crime.

Scholars have pursued two main lines of inquiry to study self-governance as a means to minimize the problem of social order. Each focuses on the internal features of the group to determine the capacity for self-governance. The sociological approach looks for answers in the density of social relations within the group (Granovetter 1985, 1992; Coleman 1990; Putnam 1993). It locates the origins of social order in historical paths of development and argues that the denser the social relations, the better the prospects for successful self-governance. According to this view, social relations underpin social order.

The economic approach also looks for answers in the internal features of the group, such as the number, heterogeneity, and discount rates of group members (Ostrom 1990; Milgrom, North and Weingast 1990; Greif 1993, 1994). It locates the origins of self-governing organizations in the economic calculations of group members. According to this view, economic interest underpins social order.

This book argues for a more political approach. It finds that when a group operates within territory controlled by a state, state policies that influence the costs of sharing information among group members often determine the prospects for self-governance. In particular, state tax and delegation policies significantly shape the incentives of group members to share information, a necessary condition for self-governance. If state agents levy high tax rates that inhibit the flow of information among group members, then the prospects for self-governance will be low, regardless of the internal features of the group. Conversely, if state agents delegate resources and governing authority that reduce the cost of sharing information, then the prospects for self-governance may be quite favorable, even where the internal conditions for cooperation are bleak. According to this view, politics underpins social order.

Institutions and Social Order

This book focuses on brokers in postcommunist Moscow, but similar problems of social order abound. Fearing that competitors will take their catch, fishermen on the Sri Lankan coast rapidly depleted their natural stock of fish and left all members of the community poorer. Lacking an external agent to enforce a truce, Serbs and Muslims in Bosnia chose to take up arms, rather than abide by a peace agreement. Unable to find a means to enforce agreements, the leaders of the Soviet Union and the United States engaged in a wasteful arms race for decades. Each of these problems is rooted in the failure of groups to create institutions to enforce agreements in the absence of a reliable third-party enforcer.

Scholars from many fields have studied the problem of social order. Robert Bates notes:

> The problem of social order stands as a classic one, and it has been posed in many forms. In political science, it is sometimes cast as a tension between private interests and the public good, between rights and obligations, or between the individual and the collectivity. In economics, it has been cast as a research agenda: under what conditions can maximizing behavior by self-regarding agents lead to allocational decisions that

> are consistent with a social optimum? . . . Sociological theories tend to emphasize two major sources of social order. One is morality, the other is coercion. . . . The problem of social order is precisely that: a problem. It can be characterized, but not resolved.[2]

In recent years scholars have focused on institutions as the most common answer to the problem of social order.[3] Properly constructed institutions can change the behavior of group members by giving them incentives to cooperate, rather than to cheat, and thereby promote social order within groups. These institutions come in many forms, both public and private. A famous and pessimistic solution comes from Hobbes (1986 [1651]), who argued that the problem of social order could only be resolved by the "Leviathan"—a coercive state that would enforce contracts and deter the less scrupled members of society. Yet group members in a variety of settings have mitigated the problem of social order without relying on external organizations, such as the state or organized crime, to enforce agreements. Rotating credit societies, collectively managed irrigation systems, neighborhood crime watch groups, and stock exchanges around the world rely primarily on their own members to write rules, resolve disputes, and levy sanctions without an external enforcer.[4] In addition, other kinds of social organizations, such as professional associations, chambers of commerce, and rating agencies, are the essential social fabric of a market economy.

Public and private solutions to the problem of social order operate simultaneously in many settings. If we look closely, all market economies rely on a mix of governance by state agents and governance by social groups. State agents often lack the time, resources, and expertise to resolve many disputes. Economic agents are typically reluctant to turn to state bodies to resolve disputes because courts are seen as slow, expensive, and uncertain. In many instances economic agents are more concerned about saving face among their trading partners than they are about being taken to court.[5] By studying the creation and performance of social institutions to minimize the problem of social order, this work focuses on an essential element of a market economy.

Social Order in a Postcommunist Setting

The countries of Eurasia emerging from decades of rule by communist parties provide especially fertile ground for studying the problem of social order. Postcommunist states throughout the region have often lacked the resources and incentives to provide basic public goods that underpin social order. In response, former communists and dissidents, workers and managers, and