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978-1-107-03016-9 - Building Business in Post-Communist Russia, Eastern Europe,  
and Eurasia: Collective Goods, Selective Incentives, and Predatory States

Dinissa Duvanova

Excerpt

[More information](#)

# 1

## Introduction

People of the same trade seldom meet together ...

– Adam Smith

In 2005, on my second research trip to Russia, I visited a tiny but long-established association of small entrepreneurs in an administrative district of Moscow. As I walked through the door, a young male secretary greeted me and offered me the customary cup of tea while I waited for my appointment with the association's president. The office was small and neat. Newspapers and magazines filled the shelves. A map of Moscow hung on the wall. The suite comprised a conference room that could accommodate a dozen people, the president's office, and a room for two other staff members. The secretary smiled awkwardly at me. I was an unusual visitor, so he did not know how to start the conversation. I asked him not to mind my presence; I did not want to disturb whatever he had been doing before I arrived.

"It's a relatively slow day," he replied. "Summer, you know. Business is slow. The craziness will start in two weeks. Then you wouldn't have a chance to catch our president in the office."

Before I had arrived, he had been listening to the news on *Nashe Radio*, a popular Russian radio station. Now he changed the station. In a strong voice, a woman sang a lively tune: "They control our steps. They control our minds." I wondered if "they" referred to Russia's communist past or the currently emerging police state. It turned out that "they" referred to state regulators: *kontrolery*.

"I really like this song," the secretary said. "This is what we're dealing with here most of the time."

"How so?" I asked.

"You see, I'm the one who meets all our visitors and answers the phone here. For the most part, people contact us when they're in trouble. We rarely hear

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from our happy members. So when they call, it's usually a complaint about yet another regulator who overstepped his limits or caused some other problems. I'm sick of hearing the same stories over and over."

That day I did not give much thought to my casual conversation with the secretary. Only later, after a couple dozen other meetings and endless phone conversations with industry leaders and functionaries, did I realize that the secretary's simplistic account of the association's role in dealing with state regulators provided the answer to the puzzle I was trying to crack.

### 1.1 The Puzzle

I went to Russia to study the formation and activities of business associations.<sup>1</sup> Prior to 1989, the post-communist countries of Eastern Europe and the former USSR lacked membership-based business associations.<sup>2</sup> After the collapse of communism, genuine membership-based business associations emerged as representative institutions of the private sector, surpassing other types of societal organizations in number, resources, and membership. The variation in membership rates across countries, however, is striking, ranging from 15 percent to 70 percent of business entities (European Bank for Reconstruction and Development and World Bank 2005). This prompts the question: why did some businesses in some countries join business associations while others did not?

Another important question is why these numerous, organizationally complex, and continuously expanding organizations are seldom implicated in rent-seeking or collusive behavior? As early as 1776, Adam Smith expressed a distrust of organized businesspeople, stating, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public" (131). His two fundamental propositions, well known in modern scholarship as the collective-action problem and special interests' rent-seeking, have guided my study of business associations.

<sup>1</sup> Throughout this book I use the term *business association* rather than industry association because not all business associations are limited to particular industries. Many are based on region or on issues of concern. In the post-communist states, national legislation defines business associations as nonprofit organizations that unite companies or their managers on professional, geographical, sectoral, or other grounds. This definition legally restricts activities of business associations and clearly distinguishes them from industrial conglomerates, trusts, and firms (vertically and horizontally integrated commercial establishments). Although some countries' laws specify the permissible missions of such associations, most do not. My analysis of the charters and publicly stated objectives of more than 350 business associations revealed that most of these associations define their objectives broadly, declaring all types of activities permitted by law. The most commonly stated goals include growth within a particular industry or market, sharing of market-related information among members, protection and representation of members' professional interests in relation to the state, and harmonization of members' interests with regard to legislation, regulation, and strategic development.

<sup>2</sup> The Soviet-style associations often did not charge membership dues and were part of the state bureaucracy. They were not rooted in membership, as their official names would imply.

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Excerpt

[More information](#)*Introduction*

3

According to the former concept, it is irrational for self-interested actors to join common-cause groups; instead, self-reliance and opportunism are their optimal strategies.<sup>3</sup> According to the latter, organized moneyed interests should always be suspect, as they tend to take advantage of disorganized consumers and short-sighted politicians.

Researching the origins of post-communist business associations, I wondered whether businesspeople were aware of the collective-action problem. Because the members of business associations often directly compete with one another for market share, why would they want to join a common-cause group, especially one that is open to public scrutiny and diverse membership? I was reluctant to conclude that post-communist businesspeople are simply irrational, wasting their time and resources on actions that are advantageous only in collective terms.

Both the public and academia tend to view post-communist business associations as having little influence over state policy and economic development (Kubicek 1996; Peregudov and Semenenko 1996; Fortescue 1997; Rutland 2001; McMenamain 2002; Lehmbuch 2003).<sup>4</sup> If associations are unimportant in lobbying for the business community's interests, however, it is unclear why firms across the post-communist world join them and why these associations grow in number and membership. Business associations' weak influence in post-communist societies contrasts with the enormous influence that individual companies have exercised; indeed, some scholars have concluded that such companies have managed to block economic reform in many post-communist states (Hellman 1998; Hellman, Jones, and Kaufmann 2000; Ganey 2001).

My puzzlement increased when I compared business associations' formation and membership across economic sectors and post-communist countries. Employer associations were numerous and prominent in highly fragmented small-business and retail-trade sectors as well as in sectors such as real estate and financial services, but not in metallurgy or coal industries. I was surprised

<sup>3</sup> Olson (1965) explained group formation as a product of club goods (selective incentives) and sanctions against free-riders. Because enforcing sanctions is costlier and the benefits are more dispersed in larger groups, business actors are easier to organize compared to more numerous labor groups. This logic, however, does not apply to a vast number of business sectors that are dominated by small and dispersed firms and heterogeneous interests. At the same time, firms with highly concentrated resources may have little incentive to act collectively but instead may pursue their interests through direct ties to public officials that crony capitalist arrangements offer. As documented in Chapters 3 and 5, the development of post-communist trade associations is not a simple product of groups' size and resource concentration, although both factors play an important role in explaining how and why some associations form whereas others fail.

<sup>4</sup> Remington (2004) describes the RUIE as "the single most powerful organized interest group in Russia" (153). Similarly, according to Fink-Hafner and Krasovec (2005), "Interest groups with more independent resources and greater power (especially economic interest groups) have succeeded in their pressure to create more institutionalized policy networks with an important influence on behalf of non-state actors" (414). However, such assessments are infrequent. Most scholars emphasize the weakness and disorganization of post-communist businesses.

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[More information](#)

to learn that some of Eastern Europe's most democratic countries with the strongest traditions of civic engagement, such as the Czech Republic and Poland, have *not* been leaders in the development of business associations; rather, their levels of participation in business associations were moderate during political and economic transition. This finding was hard to reconcile with scholars' predictions of greater organizational activity in countries with rational-bureaucratic legacies, deeper civic traditions that survived under communist regimes, and revitalized social activism that led to the peaceful anticommunist revolutions of the early 1990s (Jowitt 1992a; Schopflin 1994; Geddes 1995; Kitschelt 1999). From the standard perspective, post-communist business associations were forming in the wrong sectors and countries.

This book investigates the causes of the formation of business associations and their interaction with state institutions in the wake of the collapse of state socialism.<sup>5</sup> It advances a theory of the relationship between economic actors and the state, and contributes to ongoing debates in the study of post-communism as well as to more general studies of collective action, regulatory politics, and industrial organization. Several findings stand out. First, in contrast to popular wisdom, rates of membership in business associations are quite high in post-communist economies. Despite the purported flattened social landscape, high levels of social apathy, and incentives to work in the informal economy, people of the same trade frequently overcome the problem of collective action and come together in formal associations. Moreover, unlike accounts that declare post-communist business associations to be weak and inconsequential, this study demonstrates that these associations perform functions vital to their constituents – functions that have remained below the radar of transitional economy research.

Second, cross-national quantitative data from twenty-seven countries and qualitative data from Russia, Ukraine, Croatia, and Kazakhstan indicate that state regulatory institutions have a surprising effect on the formation of business associations. Counterintuitively, harsh regulations discourage the development of business associations, but lax enforcement of regulations, often linked to bureaucratic corruption, stimulates collective action.<sup>6</sup> Thus, it is critical to

<sup>5</sup> This research focuses on formal business associations, not business-interest groups broadly conceived. It thereby avoids the question of what constitutes an interest group. If one adopts the established view that “an interest arises from the conjunction between some private value held by a political actor – public officials or groups thereof as well as private sector operatives – and some authoritative action or proposed action by government” (Salisbury 1991, 12), civic associations that do not lobby the government are not interest groups. I find such exclusion unjustified. Unlike the literature on lobbying, this book concentrates on the organization of business communities rather than government's granting of private benefits. My approach excludes unorganized or individual demands and activities, does not require attempts to influence or lobby, and, when such attempts are present, does not specify the channels of influence.

<sup>6</sup> I define economic regulation as a direct state intervention in market decisions such as pricing, competition, and market entry or exit, regardless of whether it results in increased or hampered economic efficiency. Regulations may take different forms, ranging from trade protection and entry barriers to laws specifying property and consumer rights.

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Excerpt

[More information](#)*Introduction*

5

differentiate between two distinct concepts that are often conflated: the extent of regulation and the enforcement of these regulations. Whereas the former weakens incentives to join business associations, the absence of the latter strengthens them. The logic here is straightforward but yields a counterintuitive insight. Corrupt bureaucrats often compete with business associations to provide regulatory relief. (In exchange for bribes, the bureaucrats overlook regulatory noncompliance.) To gain members, business associations must supply meaningful, cost-effective regulatory relief.<sup>7</sup> When regulations are particularly burdensome, business associations must work harder to make membership worthwhile; as a result, fewer of them are able to form and survive. However, when enforcement of harsh regulations is lax and corruption prevails, business associations can provide a valuable service to members by protecting them from corruption and, thus, can thrive as organizations.

Third, although a large body of literature on business-state interaction contends that interest groups make claims on the state and seek protection from market forces (Olson 1965; Stigler 1971; Peltzman 1976; Grossman and Helpman 1994; Groseclose and Snyder 1996; Rose-Ackerman 1999), I argue that business associations in the post-communist setting primarily protect firms from the state. This is not to say that post-communist businesses might not engage in collusion and rent-seeking. However, conspiracy against the public has not been the primary motivation behind the formation of business associations; instead, post-communist business associations have developed in large part to counter the arbitrariness, unpredictability, and injustice of state regulatory mechanisms. This study documents how the development of business associations improves the business environment, thereby making it more predictable and favorable to business activity. Thus, my findings stand in contrast to a large body of literature on the pernicious impact of interest groups.

## 1.2 Theoretical Contributions

Although the post-communist transition has provided fertile ground for studies of business-state interactions, few studies have focused on formal associations for business representation. Researchers have investigated reform of the state (Crawford 1995; Bunce 1999; Grzymala-Busse 2007; Pickles and Jenkins 2008; Frye 2010) and informal interactions between the state and private interests (Hellman 1998; Hellman, Jones, and Kaufmann 2000; Ganev 2001; Frye 2002a), but we know little about formal representation of non-state economic actors. A comprehensive analysis of the transitional processes that redefine the state's role in the economy must include the formation of formal associations representing the business community. This book is one

<sup>7</sup> Chapter 2 models the cost of membership as one of the parameters affecting association membership decisions.

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Excerpt

[More information](#)

of the first studies of business associations across sectors and countries in the post-communist world.

Business associations, which had a very limited role in the state-controlled socialist economy, mushroomed throughout East-Central Europe and Eurasia following communism's collapse. Business associations in the new member-states of the European Union (EU) have actively participated in Europe-wide industry federations and representative bodies, assisting harmonization with EU practices and institutions. Across the post-communist world some of these associations have become prominent actors in industrial relations, assuming functions that state institutions formerly performed (see Remington 2004; Fink-Hafner and Krasovec 2005). Others have attracted media attention for their public campaigns to exert pressure on national governments and international institutions.

Because associations representing business interests shape post-communist states and markets, the dynamics of group mobilization and the mechanisms of exerting influence warrant thorough investigation. By addressing business associations as crucial institutions linking civil society, the economy, and the state, this book fills a gap in the otherwise rich literature on the post-communist socioeconomic transition and contributes to theory on interest groups, institutional development, and capitalism. The primary theoretical focus on business-state relations and the structures of economic governance make this study highly relevant to post-communist politics and economics, regulatory politics, institutional development, and economic reform.<sup>8</sup>

### *Interest Groups, Rent-Seeking, and Governance*

Special interest groups occupy a central place in the field of political economy (Olson 1965; Stigler 1971; Peltzman 1976). Traditionally, studies of organized producer interests have depicted business associations as rent-seeking vehicles of protectionism and unproductive collusion detrimental to social well-being (Grossman and Helpman 1994, 2000; Groseclose and Snyder 1996; Rose-Ackerman 1999). Recent studies of industrial relations in emerging markets have challenged this perspective with mounting evidence that business associations engage in market-friendly, efficiency-enhancing activities and benignly influence public governance (Recanatini and Ryterman 2001; Campos and Giovannoni 2005; Pyle 2006, 2011; Markus 2007; Yakovlev and Govorun 2011). This book contributes to this emerging intellectual tradition, highlighting formal business associations as nonmarket vehicles that improve business climate, efficiency, and growth. Specifically, it addresses the influence of the

<sup>8</sup> Theories of corporatism and, more recently, varieties of capitalism research are of specific relevance. Business associations are essential components of business-state-society relations. Better understanding of their economic, political, and social roles helps build a more comprehensive account of labor relations, economic policymaking, and capitalist development in post-communist countries.

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Dinissa Duvanova

Excerpt

[More information](#)*Introduction*

7

state regulatory environment on a company's decision to pursue one of two alternative strategies: opaque, direct transactions with regulators (i.e., bribery) or public collective action (i.e., participation in business associations).<sup>9</sup> This book's theoretical arguments and empirical evidence support the view that collective action by the business community is at least partly a response to malignant regulatory practices in emerging markets.

*Post-Communist Political Economy and Civil Society*

This study's primary empirical focus is on variations in the development of business associations across post-communist countries and economic sectors. Despite having much in common, these countries nevertheless vary in the number, strength, and characteristics of their emerging business associations.<sup>10</sup> Although scholars have examined the behavior and influence of business-interest groups, the reasons that business-interest groups do or do not form remains underinvestigated. What factors influence which businesses, economic sectors, and countries produce the most business associations? Post-communist comparative research has given this question little attention.

When political and economic reforms swept Eastern Europe in the early 1990s and shattered the remnants of the Soviet Union a few years later, scholars focused on the problems of democratic and economic transition. As liberal reforms in Eastern Europe and the Commonwealth of Independent States (CIS) proceeded, a twofold assessment of the development of interest groups emerged. Some scholars viewed post-communist business associations as having little influence on state policy and economic development (Kubicek 1996; Peregudov and Semenenko 1996; Fortescue 1997; Rutland 2001; McMamin 2002; Lehbruch 2003). Other scholars argued that mobilized business interests significantly influenced political and economic transition (Hellman 1998; Treisman 1998; Johnson, McMillan, and Woodruff 1999; Ganev 2001).<sup>11</sup> Although it emphasizes the importance of interest-group politics, this literature is silent with respect to the *causes* of group formation (or nonformation).

<sup>9</sup> A supplementary model relaxes this assumption and demonstrates that the major conclusions hold even if members or business associations can simultaneously engage in bribery.

<sup>10</sup> The early literature on the post-communist transition tends to emphasize Leninist legacies as a factor in the weakness of civil society in post-communist countries (Jowitz 1992a; Schopflin 1994; Geddes 1995). This emphasis seems to exaggerate similarities among Eastern European countries. These countries' experiences under communist rule substantially differed, yet the formal mechanisms of business-state relations followed similar patterns. This study investigates how diverse precommunist and communist legacies have shaped emerging business-state relations.

<sup>11</sup> A frequent argument is that business oligarchs have advanced their interests at the expense of the public interest (Shleifer and Treisman 2000). In Russia's case the banking sector (Johnson 2000) and energy sector (Lane 2001) have been identified as the most powerful business-interest groups. When such special interests gain access to political decision making, it is argued, they perpetuate the partial-transition stage that privileges their position. Frye (2002a) has critiqued this one-sided notion of state capture by business, showing that the state and business interests influence each other.

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Excerpt

[More information](#)

Scholars who underestimate the importance of business associations tend to doubt businesses' ability to overcome the collective-action problem, and those who emphasize strong economic interests concentrate on the effects of organized interests, ignoring how businesses overcome this problem. Consequently, neither approach has scrutinized business associations as a dependent variable. The question of which interests are represented in post-communist countries has important implications for the outcomes of political conflict and the general study of post-communism. Understanding why post-communist countries differ in the ways their social groups organize is an important element in identifying the trajectories of post-communist political and economic development.

### *Varieties of Capitalism*

This study's primary goal is to chronicle one aspect of post-communist economic and social transformation: the formation and evolution of business representation. This book also places emerging business representation in a comparative perspective and highlights the importance of business associations in the market economy. Significantly, different types of capitalist economies can be traced to the different roles played by business-interest groups, especially employer/producer associations.<sup>12</sup> By exploring similarities and differences in the systems of representation of business interests across post-communist countries, this book contributes to research on the varieties of capitalism and on the ways different countries organize relations between business and the state.

Business associations are important social institutions that determine the type of a capitalist economy. They shape economic coordination, industrial relations, welfare systems, skill acquisition and certification, and public policy (Whitley and Kristensen 1997; Appelbaum and Schettkat 1998; Hodgson 1998; Hall and Soskice 2001, 2004). To understand the nature of capitalism, one must understand the roles, forms, and influence of business associations. Analysis of emerging systems of business representation also provides insights into what types of capitalism will develop in post-communist countries. Post-communist countries provide excellent cases for studying this topic because business-state relations are still in the process of forming.

### *State Bureaucracy*

This book explores connections between society's economic domain and state bureaucratic structures. State institutions appear to play active roles in post-communist transitions, shaping the number, composition, functions, and, to

<sup>12</sup> Although primarily concerned with strictly economic aspects of business associations, the literature on varieties of capitalism points to these associations as the central nonmarket institutions of information transfer, standard setting, industrial-policy implementation, economic coordination, and public-policy formation (Whitley and Kristensen 1997; Appelbaum and Schettkat 1998; Hodgson 1998; Hall and Soskice 2001, 2004). Studies of the political economies of newly industrialized East Asian countries indicate that business associations are central to economic development (Johnson 1982; Lim 1983; Wade 1990; Morley 1999).



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and Eurasia: Collective Goods, Selective Incentives, and Predatory States

Dinissa Duvanova

Excerpt

[More information](#)*Introduction*

9

some extent, demands of interest groups. This study addresses central questions of political economy: How does state authority shape the way markets work by changing the incentive structures of market agents? And how do these agents interact with the state in pursuit of economic gain? As Polanyi (1944) suggested, society's economic and political spheres are not separate entities. Markets are embedded in a web of social and political institutions that regulate their workings, and business associations are an important component of this web. By investigating the factors involved in business associations' formation and influence, this book advances a general theory of the relationships among economic actors, state institutions, and society (Evans 1995).

*What This Book Is Not About*

Although this book touches on lobbying for business interests as one aspect of associational development, it is not limited to the issue of direct influence on policy formation and implementation. Through their representative associations, businesses affect the state in important and subtle ways that would be missed if I focused solely on lobbying. This study elucidates such indirect but essential influences.

By addressing the formation of business associations, this research contributes to the study of interest groups in general and to that of their relations with state institutions in particular. However, business associations are probably not the most common type of interest group operating between the state and the market. Therefore, this study's findings do not necessarily apply to other types of civil associations (e.g., unions, civil-political groups, and religious organizations). Nevertheless, this research addresses a crucial aspect of state-society relations: interactions between economic elites and the state.

Unlike many influential works on business interests, this work does not start with the socioeconomic consequences of interest-group politics. Much of the research on interest groups' influence on the state examines the conditions under which these groups positively or negatively impact economic performance, accountability, fairness, and efficiency. Existing work on the consequences of business associations, however, misses a key selection process: business interests organize in some situations but not in others. This failure to problematize the selection process by which organized interests come into being opens possibilities of serious bias. By examining the causes of interest-group formation and growth, this study tackles the selection process, providing a foundation to link causes and consequences together. It shows that business-interest groups often form in response to state institutions' failure to provide collective goods, and it highlights such groups' positive effects: institution building that results in improved business climate, efficiency, and growth.<sup>13</sup> Although this research

<sup>13</sup> Although we cannot deduce the effects of group formation from its causes, we can better understand the socioeconomic consequences of business organizational development if we understand why groups form.

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Excerpt

[More information](#)

does not directly investigate the outcomes of interest-groups' politics, by implication it does help define the economic and political roles that business associations occupy in emerging markets.

### 1.3 Empirical Evidence

To account for the formation of business associations across countries and economic sectors, I analyzed data from (1) World Bank BEEPS surveys (1999, 2002, and 2005) of businesses in twenty-seven post-communist countries<sup>14</sup>; (2) a survey of Russian business associations; and (3) structured interviews and oral histories describing the development of business associations in post-communist Russia, Croatia, Ukraine, and Kazakhstan. This study includes large-*N* statistical analysis, comparative analyses of four countries, and in-depth case studies of business associations. The use of multiple research methods allowed me to derive hypotheses for different levels of analysis (firms, sectors, and countries) and, thereby, to cross-check the validity of my inferences.

Whereas the quantitative analysis is based on secondary data, I collected my qualitative data firsthand. In my field research I collected original data on the number of business associations, their estimated membership, and the economic sectors they represent. I also analyzed oral-history records and conducted more than eighty hours of structured interviews describing the development of twenty-four Russian, sixteen Ukrainian, and five Croatian business associations. Such data were not previously available. The interviewees were fifty-three officials representing business associations and state agencies in Russia, Ukraine, and Croatia. I also collected qualitative data on the development of Kazakh business associations. Appendices A and B provide the details of my fieldwork and research instruments.

### 1.4 Summary of Main Arguments

Although a number of theories illuminate the formation of interest groups, none adequately explains the development of post-communist business associations. As I pondered interviewees' accounts of the formation and evolution of dozens of business associations – small and large, local and national, poorly funded and resource rich, well established and disintegrating – I found no uniform answers as to why these associations emerge, why they fail or succeed, or why firms join them. Establishing an entrepreneurs' league, employers' union, or other business association is a complicated process that brings together

<sup>14</sup> Although the twenty-seven countries show increasingly divergent post-communist development, they share many preexisting traits. Pooling data on association membership in all twenty-seven countries allowed me to investigate the effects of different regulatory and macroeconomic variables, and examining data from three consecutive cross-national business surveys allowed me to investigate the temporal dimension of business participation.