

**CHAPTER 2****COLLECTIVE ACTION IN AN ADVERSE BUSINESS ENVIRONMENT**

*What is the difference between a taxidermist and a tax collector?  
The taxidermist takes only your skin.*

Mark Twain

When the construction boom hit the major former Soviet cities in the early and mid 2000s, changes were noticeable to all their inhabitants. New residential and office buildings were rising to change urban topography. Against the background of the Soviet-style gray concrete architecture, new variegated styles, flamboyant décor, and space-age materials signified to every passerby the arrival of the new capitalist age. Not only the newly erected buildings but also the construction sites themselves looked rather different from familiar Soviet archetypes. Neat and clean fences, warning signs, and safety nets guarded the public from construction debris, noise, and dust.

One day, however, I was intrigued by seeing that the workers at one of the construction sites on a busy street in Almaty had replaced a decorative screen from a half-finished high-rise apartment building with a plain green rug. The decorative screen had featured the future building's façade, which looked like a natural addition to the surrounding architectural ensemble and effectively masked the construction from the public view. The first thing crossing my mind was that the contractor made changes to the building design, rendering the image printed on the huge screen irrelevant. Soon I noticed other similar screens featuring future exteriors and interiors of unfinished buildings disappearing from other busy intersections.

Puzzled, I mentioned my observation to one business person operating in the construction industry. Apparently, the wave of de-beautification of the construction sites had little to do with the changing architectural plans. In fact, the city administration was responsible for the rather mundane green and gray covers and dull fences. City officials had decided that the images printed on the screens and fences of the construction sites, irrespective of their content, had to be classified as advertisements. As with all commercial ads displayed within the city limits, these automatically became the subject of regulation and taxation. Not only did the city demand that construction companies pay high fees for displaying these images, but they also were subject to approval by the special agency.

Needless to say, large fences, screens, and boards covering unsightly construction, by a stroke of the bureaucratic pen, were turned into an expensive commodity. Many firms were not ready to pay advertisement fees, especially since the screens and fences were not designed as advertisements in the first place. The natural response was to remove them, turning construction sites once again into dull voids in the city landscape. Of course, the individual firms' responses might have been different if the stakes were higher. Fighting the city encroachment on what appears to be not only the construction firms' interests in building market reputation, but also public interest in safe and beautiful cities, however, would require something more than an individual interest - it would require a collective action.

Some firms in the post-communist settings have chosen the collective response to obstacles similar to the ones faced by the construction industry in the city of Almaty. They created and joined business associations in search of collective protection from the bureaucratic predicament. Other firms, however, have failed to organize a collective response, creating no associations to represent their interests. This chapter presents a theoretical argument specifying under what conditions the post-communist firms choose to

adopt an organizational strategy and join business associations. It outlines theoretical motivation and builds an analytical framework to guide the subsequent empirical analysis.

The question motivating the theory building is why business associations form despite the legacy of social apathy and the pervasive collective action problem. I propose a framework that explains the formation of business associations in terms of the interplay between institutional environment, regulatory regimes, and firms' interests shaped by business environment. I will argue that abusive regulatory regimes that give rise to low-level bureaucratic corruption affect group formation. In contrast to some existing theories, the theory developed here predicts that petty corruption makes it more likely that firms will join business associations.

The story of association formation I tell in this chapter starts with an assumption that business associations are the organizational means of interest representation—a standard definition of an interest group. I take a closer look at the institutional environment that affects the operation of post-communist businesses and propose a formal explanation of organizational dynamics that models firms' decisions to join associations as a response to the challenges presented by the bureaucratic environment. The central argument emerging from this chapter is that business associations arise as a defense mechanism against the regulatory pressures particularly exacerbated by corrupt enforcement practices. I argue that protection from corruption can be provided in the form of selective incentives and thus is not subjected to the collective action problem.

This theoretical chapter sets the stage for empirical tests of my arguments linking the formation of business associations to the challenges presented by the regulatory environment. I develop a set of testable hypotheses to be examined against empirical data. The rest of the book uses quantitative data to test these hypotheses and further investigates the causal mechanism behind my theoretical claims by examining qualitative evidence on how post-

communist business associations are able to provide protection from stringent and corrupt state regulations.

## 2. 1 POST-COMMUNIST BUSINESS ENVIRONMENT

A number of theories of interest group politics point to political and socio-economic factors affecting the formation of organized interests. From the modernization theory to the neo-institutional arguments, the socio-economic and political environment is seen as affecting the underlying composition of interests, institutional channels of organization and influence, and groups' opportunity structure.<sup>1</sup> In addition to institutions shaping the political environment, state bureaucratic structures shape the regulatory environment in which firms operate. During profound socio-economic transformation, post-communist firms are deeply affected by the state. The actions of state bureaucrats and the quality of state governance influence firms' economic viability, business strategies, costs, and opportunities. Rules and regulations imposed and enforced by state bureaucratic agencies, in many ways, structure the emerging markets.

In the centrally planned economy, regulations were an integral part of the comprehensive framework of the bureaucratic management of the economy and were designed to work not along with market mechanisms but, rather, instead of them. With the collapse of central planning, direct resource allocation mechanisms were abandoned. However, the rules and regulations that affected product standardization, labor managements, equipment and machinery use, and many other aspects of production and commerce were slow to change

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<sup>1</sup> Three theoretical traditions in the analysis of group formation offer alternative theoretical perspectives. Change in the socio-economic environment is the driving force behind the modernization theory of group formation (Truman, 1951; Peltzman, 1976; Olson, 1982; Becker, 1983; Mueller & Murrell, 1984, 1986). Another tradition addresses group formation as the solution to an instance of the collective action problem (Olson, 1965; Clark and Wilson, 1961; Axelrod, 1981; Taylor, 1990; Knight, 1992; Levi, 1990). Characteristics of latent groups are the major explanatory elements in this framework. The third framework concentrates on the industrial structure as the main reason behind interest organization in the economic sphere (Bates, 1981; Frieden, 1991; Hiscox, 2001).

(Hellman et al., 2002; Kaufmann et al., 2003; EBRD, 1999). Developed for the management of a centrally planned economy and with central planners' goals in mind, these regulations continued to impact the ways products were designed, produced, transported, and sold in post-communist transitional economies. As enterprise managers began discovering new market opportunities emerging after the dissipation of direct state controls, they started searching for ways to get around slowly changing rules and regulations. This desire to ease up bureaucratic costs associated with conducting business paved the way to bureaucratic corruption, which, by the mid-1990s, became the notorious companion of economic transition.

#### *Corruption in the Post-Communist Business Environment*

Anyone who has lived, traveled, or done business in post-communist Eastern Europe can tell (or at least have heard) a tale of an unpleasant encounter with a bureaucrat—a customs official, policeman, bank clerk, fire inspector, or residency registration officer. There is a multitude of rules and regulations explaining, amending, and “clarifying” laws, and both an average person and a not-so-average businessman usually feel lost when confronted by officials enforcing these rules. It appears that the rules are made to confuse the people who are supposed to follow them. In this respect, bureaucratic corruption—a distasteful practice nobody would want to defend—often provides the most convenient and “customer-friendly” way of conducting business with bureaucrats. If you can show your gratitude, public servants—otherwise not very customer-friendly—might go an extra mile to help you. While navigating across the field of bureaucratic obstructions is difficult, corruption appears to be the path of least resistance when dealing with public servants. If you are a businessman who needs to obtain registrations, licenses, permissions, and approvals from regulatory state

agencies,<sup>2</sup> the path of least resistance is typically the only way to ensure your business can function smoothly. Illegal incomes of corrupt bureaucrats depend on their patrons, and since businessmen can pay more than average citizens, they are subject to greater attention from bureaucrats.

Corruption has become the subject of much of the post-communist transition research (Boycko, et al. 1995; Hellman et al., 2000; Gaddy & Ickes, 1999; Miller et al., 2002). It has been argued that petty corruption has a debilitating effect on post-communist businesses (Murray, 1999; Frye, 1998; Webster, 2002; *The Impact of Corruption on Small Business*, 2002). It is generally considered a formidable obstacle to the effective functioning of emerging markets and a great impediment for businesses in transitional countries. But does it also impede the emergence of legitimate interest groups defending business interests? According to some theoretical perspectives, corruption opens informal channels of interaction between individual firms and state bureaucrats, thus rendering superfluous any collective action on the part of a larger business community (Leff, 1964; Huntington, 1968, McChesney, 1997). Therefore, one might expect that in highly corrupt systems—including many post-communist countries—fewer legitimate associations representing business interests will emerge. Before proceeding to the presentation of these arguments, however, a proper definition of administrative corruption is needed.

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<sup>2</sup> The number and control power of such regulating agencies vary by country. Comparative data spanning all post-communist states is unavailable; however, evidence points to a vast divergence. Frye (1998), for instance, reports that in Russia, retail traders, on average, are inspected by four different bureaucratic agencies. By comparison, Polish shopkeepers are inspected by 2.6 agencies. This translates into differential bureaucratic barriers with an average of 19 inspections per year in Russia and nine in Poland. Other accounts point to cases of even more severe regulatory pressure. In Moldova, according to a survey of business people, enterprises are inspected, on average, 38 times per year (*The Impact of Corruption on Small Business*, 2002). According to the president of Almaty Entrepreneurs' Association, Viktor Yambaev (2005), of 56 controlling and supervising state agencies, 30 are the most harmful to the development of small business. For a worldwide comparative measure of bureaucratic barriers, see Brunetti, et al. (1997).

*Two Types of Corruption*

This study uses the term corruption to represent the abuse of a public office to obtain personal and narrowly defined group benefits that fall outside entitlements designated by law. Corrupt practices that might exist outside the public sphere are not included in this definition. Two broad types of corruption have been identified in the literature: low-level administrative or petty corruption and political corruption or state capture. The distinctions have been drawn primarily at the level of state-business interactions.<sup>3</sup> On the one hand, bureaucratic corruption is something that affects businesses, households, and low-level local bureaucrats in their day-to-day economic and administrative functions. Grand-scale corruption or state capture, on the other hand, affects industrial tycoons, financial magnates, and high-ranking public officials and has an impact on the allocation of public funds, large contracts, and property.

The distinction between these two types of corruption can be demonstrated on a stylized Banker-Baker contrast. Following Webster's (2002) imaginary petty businessmen and an executive of a large holding company, quite distinct forms of business-state interactions can be observed. For the small businessman—the Baker—the majority of interactions with the state would take the form of routine encounters with local tax inspectors, policemen, registration officers, and fire and health department officials and would involve obtaining the incorporation documentation, undergoing inspections, filing tax reports, and applying for licenses and permits. The manager of a large company—the Banker—is more likely to interact with ministerial staff and local and national politicians through formal

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<sup>3</sup> In addition to the petty/administrative vs. capture/grand political corruption, the distinction between these two distinct types of corruption has also been conceptualized in terms of the *ex ante* vs. *ex post* corruption in relation to bureaucratic screening of private beneficiaries (Gurieva, 2003) and “corruption without theft” vs. “corruption with theft” (Shleifer & Vishny, 1993). The first reflects the fact that *ex ante* administrative corruption that involves “speed” or “blinders” fees removes administrative pressures from all economic agents, regardless of their type: both good (compliant and eligible) types and bad (disqualified) types are provided with a convenient way around the red tape. The *ex post* corruption is less benign in a sense that the information about the actual type of business is known to the bureaucrat who colludes with the bad type to supply benefits to which the beneficiary is not eligible. In a similar vein, corruption without theft refers to the cases where business is not getting any additional transfers from the government. When corruption leads to redistribution of resources by the government in favor of the bribe-paying economic agent, the “theft” of public resources occurs, resulting in a diminished social welfare.

(working groups, political functions, conferences, and roundtables) and informal channels (elite networks, “business” dinners, and seemingly business-unrelated social events). If both of these businessmen are to exploit the power of bribes, the nature of the corruption they would be involved in would be drastically different.

A baker’s corruption would most likely involve payments to allow him to “keep his business running” (Webster, 2002, p. 11). The side payments to state inspectors and bureaucrats this Baker makes are not purchasing any advantages: he is not getting any services from the state bureaucrats in addition to the ones they are expected to provide by law. He might get some reduction in the cost of running his business through the “blindness fees” paid to officials to overlook his business’s irregularities, but it comes at the cost of increased dependency on those corrupt bureaucrats in the future.

A banker’s corruption is likely to be of another type, often referred to as “state capture” (Hellman et al, 2000). State capture is characterized by close relationships between political decision-makers and large businesses that dictate the rules of the game to ensure that continuing streams of benefits are attained at the expense of other (sometimes more efficient) economic actors while producing socially sub-optimal economic outcomes. Large businesses’ payments to politicians and high-ranking bureaucrats are likely to purchase preferential treatment in export-import operations, public procurement, selective protectionism, and other economic advantages over the firm’s competitors. “This is the payment of bribes to shape the policy and legal environment to the captor firm’s advantage” (Webster, 2002, p. 12). Economic benefits for the captor firms are usually immediate and conspicuous, while costs are often long-term and are dispensed across society at-large.

Even though grand political corruption clearly has a stronger negative connotation, it would be misleading to think of petty administrative corruption as an insignificant phenomenon that has only a marginal effect on post-communist societies. Administrative

corruption is less likely to be the focus of mass media coverage like that of scandals implicating high-visibility business and political elites. Murky privatization deals, private enrichment through government concessions, multi-billion dollar contracts, and the scandalous re-nationalization of private industries are closely followed in the press. Such corruption, although having long-term (and sometimes immediate) effects on a large number of businesses and households, is not directly experienced by the average businessman. This is in sharp contrast to the low-level administrative corruption felt by economic agents in their daily activities.

Although the scale of corrupt dealings at the lower levels of state bureaucracy is small, the amounts of bribes transferred in the immense number of corrupt transactions involving millions of households and enterprises adds up to a colossal number. The cost of such corruption not only involves the redistribution of resources from productive (enterprises that reinvest them) to unproductive users (bureaucrats that are most likely to spend them on private consumption), but also the distortion of state regulatory mechanisms, disruption of tax collection, undermining of public safety monitoring, interruption of contract enforcement, and weakening of the social safety net. Petty corruption therefore impinges on state capacity. Corrupt bureaucrats find their rewards not in ensuring the meticulous workings of the state machine but rather in complicating the bureaucratic process that fuels the demand for corruption. Even if the central government is committed to a clean, efficient, and stable legal environment, local corruption on the part of low-level bureaucrats entrusted with carrying out regulatory orders might stall otherwise well-intentioned reforms.<sup>4</sup>

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<sup>4</sup> For an illustration, consider the 1995 tax reform in Russia that was designed to simplify taxation mechanisms by introducing a single, flat 10% tax on small enterprises. The reform was introduced in response to a widespread criticism of the Russian taxation system that taxed not only profits and revenues, but also physical transfers of goods and assets. Strong complaints were voiced about the complexity of old tax legislation that was virtually incomprehensible to business practitioners. Existing legislation was open to multiple interpretations, creating loopholes for de-facto tax reductions achieved in collusion with tax authorities. With the falling tax collection rates and growing budget deficit, the Russian government hoped that a simplification of taxation mechanisms and a reduction of businesses' tax burdens would, in fact, increase state revenue and stimulate domestic investment. The 1995 law, however, gave local governments the responsibility for its implementation

*Two Arguments about Regularity Regimes, Corruption, and Formal Organization of Businesses*

Equipped with the definition of bureaucratic corruption, I now return to the effects of corrupt regulatory practices on group formation. It's been argued that petty corruption has a debilitating effect on businesses in the transitional countries (Murray, 1999; Frye, 1998; Webster, 2002; *The Impact of Corruption on Small Business*, 2002). Corruption increases uncertainty, undermines institutional development, and decreases provision of public goods that are important components of the business environment. If businesses are affected by the regulatory and institutional environment in which they operate, the extent of administrative corruption should have an effect on the levels of organizational membership. The standard expectation developed in the literature is that businesses should be *less* likely to form legitimate associations in highly corrupt systems. Two explanations have been proposed.

One theoretical argument linked to Leff's (1964) and Huntington's (1968) view on corruption in developing countries implies that because corruption allows *individual* firms to solve their problems by bribing public officials, it reduces the need for collective action and formal organization.<sup>5</sup> This notion of corruption as means of reducing government's administrative rigidity is rooted in the Coasian theory predicting that, under costless transactions, any market-driven reallocation of resources leads to a more efficient social outcome (1960). Thus, side payments to bureaucrats allow more efficient producers (those willing to pay the highest bribes) to acquire access to otherwise unattainable markets and resources. Corruption becomes a productive activity, leading to Pareto-efficient outcomes. Bureaucrats receive bribes while entrepreneurs acquire opportunities to pursue profitable activities unavailable under rigid state regulations. According to this line of thought, since

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that, in effect, led to blocking the central government's intent. In St. Petersburg, for instance, authorities imposed an \$8,500.00 fee on enterprises willing to switch to the simplified taxation scheme (Murray, 1999). It has clearly been a case of bureaucratic rule-making.

<sup>5</sup> See also Harstad and Svensson (2005) for similar treatment of corruption.

state interventions are, for the most part, counter-productive (e.g. less efficient than markets), society, as a whole, only gains by reducing, albeit through corrupt mechanisms, the number of administrative barriers limiting economic activities.

This notion of corruption as a productive activity has direct implications for the formal business organization. Here corruption becomes the substitute for other means of problem solving (such as lobbying or self-regulation) that require firms to organize.<sup>6</sup> According to such a perspective, the prevalence of personal channels of influence in post-communist settings is likely to undermine the formation of business associations, making any collective action on the part of firms superfluous. If this is true, one should observe low levels of participation in business associations when corruption is widespread.

The second argument advocated by McChesney (1997) adopts a different notion of corruption but arrives at the same prediction—that corruption and stringent regulation should reduce associational membership. McChesney sees corruption as a form of extortion by bureaucrats. In his framework, politicians and bureaucrats threaten businesses with the imposition of new regulations, in an expectation that an organized business will channel financial contributions to prevent those regulations from happening. According to this argument, the easier it is to identify these potential clients, the less problematic it becomes for corrupt officials to extort resources. By organizing, businesses become an easier target for extortion because organization facilitates exchange of information about proposed regulations and promotes collective lobbying efforts. Therefore, where bureaucrats and politicians are corrupt, there is a disincentive to organize. If this logic is correct, corruption should negatively affect group formation.

To sum up, various arguments have been proposed in the literature about the possible effects of the state regulatory environment. Such an environment is of major importance to

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<sup>6</sup> Operating under the assumption that corruption is an alternative to lobbying, Campos and Giovannoni (2005) found that lobbying is more effective than bribery in transitional countries.

transitional firms because it affects the way of conducting business and contributes to the cost of that enterprise. Of particular relevance to post-communist countries are the arguments about the state bureaucratic institutions responsible for enforcing the rules and regulations directly affecting economic activities. These institutional constraints, being characterized by high levels of unpredictability and, in many post-communist countries, by bureaucratic corruption, deserve special attention as having perhaps the most immediate effect on business interests.

## **2. 2 BUSINESS ENVIRONMENT AND BUSINESS ORGANIZATION: THE THEORY**

Regulatory rules affect production processes, relations with customers and suppliers, capital and labor hiring decisions, and other important economic choices of post-communist enterprises. These and many other rules and regulations comprise the regulatory environment in which firms operate. If businesses are affected by this regulatory environment, which, in the post-communist countries, is highly corrupt, the extent of administrative corruption should have an effect on the levels of organizational membership. The standard expectation is that businesses should be less likely to form legitimate associations in the highly corrupt systems. Here I present an alternative argument relating business environment to participation in business associations. The explanation I propose is the exact opposite of the standard arguments outlined above. I take into account the tremendous cost of corruption and argue that associations arise as defense mechanisms against corrupt regulatory environments. Bureaucratic corruption in the context of implementing and enforcing state regulations, therefore, stimulates formal businesses organization.

The arguments postulating the negative effects of corruption on group formation have concentrated either on the opportunities corrupt transactions present to businesses (e.g.

reduction of red tape, avoidance of bureaucratic restrictions on businesses, reduction of paperwork) or on the victimization of businesses by corrupt bureaucrats. The first argument under-emphasizes the costs of corruption to businesses; the second overemphasizes bureaucratic extortion and paints businesses as passive victims of predatory state behavior. I contend that these frameworks are one-sided.

On one hand, consider the following threats corruption poses to businesses. As the costs of regulations and bureaucratic inefficiency mount, the interests of individual businesses come under greater pressure. As the extent of corruption grows, individual firms spend more resources “greasing the wheels” of the predatory bureaucratic machine (Huntington, 1968, p. 386). As corruption penetrates more and more bureaucratic agencies and as the amounts of bribes rise, costs mount on businesses. Corruption directly threatens the interests of economic actors, and thus, we cannot consider it an absolute gain to business. At the same time, even in the highly predatory regulatory environment, where bureaucrats are manipulating regulatory procedures to extort resources from firms, corrupt engagement provides some benefits for businesses. By paying bribes, firms avoid much costlier regulatory compliance and gain a comparative advantage over their competitors who are reluctant to pay bribes. Therefore, the notion of corruption as an absolute loss for the business is also faulty.

In developing my argument, I make two assumptions. First, businesses incur costs associated with regulatory compliance. Second, bureaucrats can overlook noncompliance in exchange for bribes. A regulatory environment consists of rules, regulations, and enforcement mechanisms. The latter usually involve specialized state agencies, courts, and the police. Some regulations are general, such as public safety requirements or traffic regulations, and apply to all commercial and non-commercial agents. Others are specific to business (e.g. accounting standards and labor laws) and particular industries (e.g. environmental protection, health safety, banking regulations, and professional licensing).

Compliance with the rules regulating a particular sphere or economic activity requires not only specially trained staff (e.g. accountants, attorneys, or human resources specialists) but also additional managerial time and effort involved in learning about and supervising the implementation of existing regulatory requirements. Regulations might also mandate product specifications and the adoption of certain production, transportation, and distribution practices that increase net costs for businesses. Regulations, at least in theory, are designed to create more reliable property rights regimes, cost-effective information-sharing, predictable business climate, and effective contract enforcement. Although these are ultimately beneficial to the economy at large, they come at a cost to businesses.<sup>7</sup> Since regulatory compliance entails costs that are not directly linked to an immediate and noticeable increase in benefits to a firm, firms are interested in minimizing the cost of compliance.

The quality of compliance-enforcing institutions—the state bureaucracy—affects the ways of solving this cost-minimization problem. When dealing with grossly ineffective state bureaucrats and poor enforcement mechanisms, businesses might choose to disregard regulatory prescriptions.<sup>8</sup> When state bureaucracy is effective, professional, “clean,” and capable of persecuting non-compliance, firms might seek organizational and technological innovations that reduce the cost of compliance with the rules and regulations governing their activities.<sup>9</sup> The third option, and the one that best characterizes most post-communist cases, is a bureaucracy capable of enforcing rules and regulation but lacking sufficient motivation to do the job.<sup>10</sup> Under these conditions, businesses are deterred from overt non-compliance but have an opportunity to strike corrupt deals with rule-enforcing and monitoring bureaucrats.

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<sup>7</sup> The benefits of regulatory regimes, assuming the latter are well-intentioned and not rigged in favor of particularistic interests, are classic public goods. Although beneficial to the group, their cost to individual businesses gives an incentive to free-ride.

<sup>8</sup> I am indebted to Marcus Kurtz for making this point with the reference to some poorly governed Latin American countries.

<sup>9</sup> They might also seek political solutions by influencing local and national authorities that supervise bureaucrats and design regulatory practices; however, this route is less rewarding when bureaucratic autonomy is high.

<sup>10</sup> This “lack of motivation” can be traced to inadequate pay, lack of effective political supervision, and the perverse incentive structure of the poorly designed bureaucratic institutions. The sources of bureaucratic susceptibility to corruption, however, are beyond the scope of this research.

The bureaucrats are in the position to derive supplementary income from “speed money” or extra unofficial fees for the official services they perform, bribes and favors designed to reduce bureaucratic red tape, and “blindness fees” or bribes for a deliberate failure to notice noncompliance.

The bureaucrats are willing to take bribes as long as the benefits of supplementing their income exceed the costs associated with losing their jobs or being otherwise prosecuted for corrupt behavior. As long as the benefits of reducing the cost of regulatory compliance through such corrupt dealings are greater than the cost of bribes, businesses are willing to pay. The equilibrium bribe will reflect the cost of regulatory compliance and the cost of corrupt behavior. Thus, corruption might spread or diminish as a result of better deterrence (anti-corruption measures) or as the extent of regulatory intervention (and, thus, the cost of regulatory compliance) changes.

When facing an invasive regulatory environment and costly corruption, businesses largely benefit from the introduction of alternative ways of reducing regulatory costs. The long-term benefits of engaging in corrupt behavior are diminishing, because corruption increases businesses’ vulnerability, creates a dependency on bureaucrats, and limits the availability of legal enforcement (so the bureaucrats can cheat with impunity). When corruption becomes costly to sustain, businesses can resort to alternative mechanisms for advancing their economic interests by contributing their resources to legitimate institutions—business associations. Business associations become beneficial, because they allow firms to reduce regulatory costs and avoid predatory bureaucratic behavior. By joining business associations, individual firms might be better able to protect their economic interests without resorting to illegal and corrupt practices.

Business associations—organized groups of business owners or firms—are well-equipped to act as agents, reducing the cost of regulatory compliance for their members.

Organization stimulates the transfer of information about effective strategies of dealing with state regulatory regimes, helps develop legal protection mechanisms, enables self-regulation that preempts bureaucratic intervention, provides better access to political decision-makers to report instances of low-level bureaucratic inefficiency and abuse, and makes bureaucratic misdeeds more visible. When corruption is costly, a legitimate means of dealing with regulatory pressures might, in fact, provide greater advantages in defending firms' economic interests.

By organizing into associations, firms can simultaneously protect themselves from state regulatory intervention and bureaucratic predation. Associations can become a medium for coordination, information transfer, representation, and self-regulation. By pooling their resources, organized firms can better navigate through the complicated rules and regulations structuring their economic activities. They may also institute more effective and beneficial regulatory frameworks. When state regulations are complicated and corrupt bureaucrats hold a monopoly over their implementation, business associations capable of interpreting, navigating, and substituting for state regulatory regimes become much more attractive alternatives. The more widespread the corruption, the greater the gains derived from joining such associations. Thus, at higher levels of corruption, the incentives to form associations should also be higher.

This argument suggests that business associations provide the selective benefit of reducing the cost and increasing the benefits of regulatory compliance and coordination and thus, compete with bureaucrats who might offer impunity to non-compliant firms through corrupt transactions. Business associations, therefore, do not directly reduce instances of corruption but, rather, make their members less likely to engage in corrupt relations. One could also logically infer, when most of the firms in a region or bureaucratic jurisdiction join associations, corruption should become less attractive to bureaucrats. The protection from a

hostile regulatory environment that business associations supply for their members, is thus better seen as a club rather than as a purely collective good. As with other club goods, protection and self-regulation are excludable but non-rival, and its net benefit is an increasing function of associational membership. In the following pages, I formalize this argument.

### **2.3 A MORE FORMAL APPROACH**

Here I model businesses' decision to participate in associations as a strategic interaction between businesses, state bureaucrats, and associations. Business behavior under regulatory regimes is conditioned by the cost of compliance with the rules and regulations as well as by the cost of alternatives to compliance. I arrive at predictions opposite to the standard arguments about relations between corruption and collective action. I specify conditions under which the organizational response (forming business associations) becomes the optimal strategy for businesses. Consider the following model of business participation in voluntary associations.

#### *Model Assumptions*

As discussed in the previous section, I start with two plausible assumptions about bureaucrats and businesses. First, I assume that businesses incur costs associated with regulatory compliance—obtaining licenses, permissions and certifications to operate; meeting various public, environmental, consumer, and worker safety requirements; ensuring state-enforced quality standards; and keeping up with paperwork required by tax and customs authorities, local administrations and various ministries and specialized agencies—and they want to reduce that cost. Compliance with regulations imposed by the state is costly not only because of the direct monetary transfers (taxes, fees, and wages), but also because of monetary costs of adopting required business practices (having a specialist on staff, using

more expensive equipment and technology) along with non-monetary costs expressed in managerial time spent dealing with regulatory state institutions. In the model, these costs are factored into the businesses' profit maximization function. The second assumption is that the bureaucrats can overlook noncompliance with the regulatory regime on the part of the businesses in exchange for bribes.

The total cost associated with running a business can be broken down to the market cost of production and the cost of compliance with the regulatory environment that includes taxes, registration, licensing, inspections, managerial time, etc. Firms maximize their profits by increasing revenues and reducing costs. It is in their best interests to reduce the cost of regulation. If we allow a firm to have little market power, making it unable to manipulate its market-related costs and revenues through market strategies and technological innovations—a special case of a firm in competitive market settings—reduction of regulatory costs becomes the more feasible way to increase profits. One of the possible ways of reducing regulatory costs—and this is consistent with Huntington's view—is offered by corruption. Speed fees reduce processing and managerial time spent dealing with the state bureaucracy, while blinders fees allow businesses to avoid costly environmental and labor regulations, use unapproved equipment and production processes, and hide taxable transactions. A profit-maximizing firm might find it advantageous to strike a corrupt deal with a regulating bureaucrat and pay bribes in exchange for violating costly regulations. As long as bribing is cheaper than compliance, a firm prefers one to the other. In other words, it will pay bribes up to the amount equal to the cost of regulatory compliance, subject to the total profit constraint.

### *Actors and Strategies*

The model has three players: a firm ( $F$ ), a bureaucrat ( $B$ ), and an organization ( $O$ ). All are assumed to be rational utility maximizers. The firm maximizes income (profit) or the

difference between revenues and costs:  $I_F = r - c$  where  $I_F$  is income,  $r$  is total revenue, and  $c$  is total cost. Businesses operate under the total budget constraint set by  $0 \leq I_F = r - c$ . The cost ( $c$ ) is disaggregated into production cost ( $c_p$ ) and regulatory cost ( $c_r$ ). The bureaucrat maximizes his personal income rather than pursues public interest. The bureaucrat's income is derived from his/her salary and any bribe ( $b$ ) he/she might receive as a "side payment" from the firm. Provision of such "additional" bureaucratic services does not entail any direct monetary costs. The organization's income is a function of the membership and consists of the difference between dues ( $D = \sum_{i=1}^n d_i$ ) charged and a schedule of particularistic goods  $G, (g_1, g_2, \dots, g_n)$  provided to its members. The firm receives the particularistic good ( $g$ ), or selective incentive, in the form of legal and professional help in complying with rules and regulations. The particularistic good is non-rival but perfectly excludable, and there is an economy of scale in providing  $g$ .<sup>11</sup>

The firm chooses among three options for satisfying regulatory requirements: *comply* with existing regulations at a cost of  $c_r$ , *bribe* the bureaucrat, or *join* the organization and receive assistance in complying with existing regulations.<sup>12</sup> The bureaucrat chooses to be *honest* or *corrupt*; a corrupt bureaucrat must decide on the amount of a bribe,  $b$ , to charge the firm in exchange for overlooking regulatory violations. The organization decides on the level of dues ( $d$ ) and on the amount of a particularistic good ( $g$ ) that will be provided to the firm, subject to  $F$  paying  $d$ . If the firm and bureaucrat engage in corrupt behavior, both risk being

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<sup>11</sup> For a member firm  $i$ , the selective benefit  $g_{(i)}$  is a function of the overall club good ( $G$ ) provided by an association,  $g_i = f(G)$  such that  $g_i > \frac{G}{n}$ , where  $n$  is membership.

<sup>12</sup> A fourth strategy in fact exists. The total profit constraint means that if the cost of regulatory compliance exceeds a firm's revenue minus the cost of production, and other strategies are not available, the firm might be forced to go under. Operating illegally, the firm runs the risk of being prosecuted, thus private protection mechanisms, including mafia-type organizations, are going to ensure firms' continuing operation in the illegal sector. The firm's activity *per se* is not illegal—it might continue producing legal products and providing legal services. What makes the firm's operations illegal is that it exits regular regulatory relations with the state, such as paying taxes, obtaining permits and licenses, and submitting its practices and products to state control and protection. Such strategy, however, goes beyond the scope of this investigation.

prosecuted with probability ( $p$ ) and paying a fine, ( $f$ ). Under three strategies available to the firm it maximizes income, ( $I_F$ ), as defined below.

$$I_F(\text{comply}) = r - c_p - c_r$$

$$I_F(\text{bribe}) = r - c_p - b - pf$$

$$I_F(\text{join}) = r - c_p - c_r - d + g$$

The bureaucrat maximizes income, ( $I_B$ ), where  $s$  is salary.

$$I_B(\text{honest}) = s$$

$$I_B(\text{corrupt}) = s + b - pf$$

All variables are assumed to be non-negative and  $p$  ranges from 0 to 1. I further assume that the organization's payoff is an increasing function of membership and is greater when  $F$  joins than when  $F$  does not join. In offering the dues/benefits schedule, the organization therefore maximizes ( $D - G$ ) or, equivalently, minimizes ( $g - d$ ), subject to  $F$  joining.

The bureaucrat and the organization make simultaneous proposals to the firm. The bureaucrat proposes a bribe, ( $b$ ), and the organization proposes dues, ( $d$ ), and a selective good, ( $g$ ). The firm then chooses *comply*, *bribe*, or *join*. The outcomes will be perfect Nash equilibrium. The firm chooses *join* over *comply* if and only if  $I_F(\text{join}) > I_F(\text{comply})$  or, equivalently,  $g > d$ . Similarly, the firm chooses *join* over *bribe* if and only if  $I_F(\text{join}) > I_F(\text{bribe})$  or  $c_r + d - g < b + pf$ . Hence, in order to entice the firm into the organization, the organization must offer a combination of ( $g - d$ ) such that

$$(1) \quad g - d > c_r - b - pf.$$

The bureaucrat is corrupt whenever  $I_B(\text{corrupt}) > I_B(\text{honest})$ , or

$$(2) \quad b > pf.$$

To entice the firm into corrupt behavior, the bureaucrat must offer a bribe such that  $I_F(\text{bribe}) > I_F(\text{join})$ , or

$$(3) \quad b < c_r + d - g - pf .^{13}$$

Notice from (3) that if the organization proposes  $(g - d) = c_r - pf$ , then the necessary and sufficient condition for the firm to bribe rather than join is  $b < 0$ . The bureaucrat, however, will be honest rather than offer a negative bribe, and so for  $(g - d) = c_r - pf$ , the firm joins rather than bribes, and the bureaucrat chooses to be honest. In addition, assuming  $c_r > pf$  so that  $g > d$ , the firm joins rather than complies. This will not be an equilibrium, however, because the organization can attain greater utility and still entice participation by offering less than  $(g - d) = c_r - pf$ . The smallest  $(d - g)$  the organization can offer and still deter the bureaucrat from corrupt behavior is  $(d - g)$  such that  $b < pf$  in (3), and the bureaucrat prefers honesty. The organization's minimum offer that will entice the firm into membership is therefore  $(g - d) = c_r - 2pf$ , assuming  $c_r > 2pf$ . Given this offer, the bureaucrat's best response is honesty, and the firm's best response is to join.

### *Implications*

Suppose organizations are more likely to thrive the smaller  $(g - d)$  is; that is, the greater the dues they can charge relative to the particularistic goods they offer. A couple empirical predictions then follow. First, *ceteris paribus*, organizations should be more prevalent in regimes where  $p$  and/or  $f$  are relatively high. Second, *ceteris paribus*, organizations should be less prevalent in regimes where  $c_r$  is relatively high. Third, and most important, all other things being equal, organizations should find it easier to entice participation when  $b$  is high. Let us consider these implications closer.

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<sup>13</sup> The bribe should simultaneously satisfy  $I_F(\text{bribe}) > I_F(\text{comply})$ , so that  $b < c_r + pf$ .

Since the organization minimizes  $(g - d)$ , the lower  $g - d$  guaranteeing participation, the greater the incentives for establishing an association. Lower  $g - d$  means that in order to induce participation the organization could either charge the firm higher dues,  $(d)$ , or provide fewer benefits,  $(g)$ . Remember that  $F$  joins rather than bribes then condition (1) is satisfied. Since both sides of inequality (1) are positive, when terms  $pf$  and  $b$  increase, the corresponding difference  $(g - d)$  decreases. Ceteris paribus, this means that when fines  $(f)$ , probability of prosecution  $(p)$ , and bribery  $(b)$  are high, the organization can entice firms to participate by offering either lower particularistic goods  $(g)$  or higher dues  $(d)$ . At the same time, as  $c_r$  increases,  $(g - d)$  also increases, meaning that when regulatory compliance is costly, the organization has to offer a particularly lucrative combination of benefits and contributions to attract firms. The model predictions, therefore, suggest that all other things being equal, organizations should find it easier to form and attract members in regimes marked by higher bribery, lower regulatory costs, and more serious anti-corruption measures.

The latter of these implications comes as no surprise given the conventional wisdom. When corruption is costly, either due to severity or certainty of punishment, corrupt behavior is deterred, and participation in business associations becomes a more attractive strategy for defending business interests. The other two implications are somewhat counter-intuitive. It can be supposed that costly regulations would stimulate the formation of legitimate associations demanding the reduction in regulatory pressures. On the other hand, when regulatory costs are high, associations have to work harder to provide cost-effective regulatory relief that would attract members. Therefore, in stringent regulatory regimes it should be harder to form an association. Two forces are at play here. Recognize, however, that costly regulations should provide greater impetus for the firms to join. On the other side, they simultaneously make it harder for associations to provide regulatory relief. Thus, it

should be the case that when regulatory pressures are high, existing associations should provide greater member benefits.

Lastly, and most importantly, the model demonstrates that all other things being equal, organizations should find it easier to entice participation when bribery is high. When firms are spending more resources on bribes, associations should find it easier to organize and attract member contributions. Firms will be willing to contribute resources to the associations up to the amount they pay in bribes for avoiding regulatory compliance.<sup>14</sup> This prediction contradicts the conventional arguments about the negative relation between corruption and legitimate collective actions, but it is consistent with the notion that business associations provide protection against a corrupt bureaucratic environment.

#### **2.4 MODEL EXTENSIONS: LONG-TERM CONSEQUENCES**

Although the presented model does not reflect the over-time dynamics of interaction between the state bureaucrats, businesses, and associations, it is easy to think of the long-term implications. One of these extensions generates expectations in the sphere of organizational dynamics, the other in respect to bureaucratic probity. These extensions do not require additional assumptions and follow the basic intuition. They do, however, provide additional dimensions for thinking about business-state relations and the role associations play in modifying them. I briefly outline the rationale for expecting certain long-term dynamics based on the presented model.

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<sup>14</sup>Further notice that, in the absence of an organizational alternative, bribes charged by bureaucrats are given by  $b < c_r + pf$ . Thus, there is a relationship between the cost of regulatory compliance and bribes. This, however, is changed once the organizational strategy becomes available.

*The Snowball Effect of Participation*

Notice that the model assumes the existence of a business association that a firm is able to join. This, however, is not an adequate description of a post-communist system of representation which, for the most part, lacks the pre-existing collective action. In fact, one might wish to think of a situation in which the first firm that chooses “participatory” strategy, ( $F_1$ ), in fact establishes an association. In this case, at time  $t$  the firm  $F_1$  is the only contributor of organizational dues,  $d_t = D$ , and the only consumer of the benefits provided by the association,  $g_t = G$ . Assuming that organizational benefits are non-rival goods, when the second firm ( $F_2$ ) joins an association at time  $t+1$ , to receive the same level of club benefits ( $g_{t+1} = g_{2t+1} = G$ ),  $F_1$  can contribute  $d_{t+1} = D - d_{2t+1}$  such that for constant benefits ( $g$ ),  $d_{t+1} \leq d_t$ . This captures the intuition about the start-up costs exceeding the costs of subsequent membership.

Naturally, when an organization provides non-rival benefits, organizational strategy becomes even more rewarding at higher levels of participation. As time goes by, organizations mature and attract more members. One should expect the difference between benefits and costs of participation ( $g - d$ ) to increase over time. From Equation (3), which solves the model in favor of participation, as  $d$  decreases or  $g$  increases with the addition of new members, ( $g - d$ ) goes up. The greater the difference ( $g - d$ ), the larger the corresponding term  $c_r - 2pf$ . As ( $g - d$ ) goes up,  $c_r$  increases and  $p$  and  $f$  decrease, meaning that at higher participation levels, firms start joining associations under otherwise restrictive conditions of extensive regulatory regimes and low corruption costs. Thus, once an organizational strategy has been chosen by a group of firms with relatively high regulatory and corruption costs, other firms that had been benefiting from corruption are likely to follow suit. Assuming that the provision of organizational benefits is an economy of scale and a

form of non-rival good (not necessarily purely non-rival), increasing organizational membership changes the payoff structure for the remaining firms in the economy. Such changes make the participatory strategy more rewarding for all.

### *Decreasing Corruption*

While the first dynamic extension of the model concerns the pay-off structure of the firms, the second builds on the changing bureaucratic pay-offs. If by joining associations businesses end their corrupt transactions with the bureaucrats, in the long run, the development of business associations should lower the demand for corruption. According to the logic of my argument, in order for the bureaucrats to entice the firms into corrupt transactions, they must offer a lower rate for the bribes. In the model, however, the threshold for the supply of corruption is set by the term  $pf$ . As the demand for corruption drops, a bureaucrat whose bribe level drops below her reservation level  $pf$ , therefore prefers honesty over corruption, and this leads to the decline in the overall levels of corruption and an improvement in bureaucratic quality. As more firms join associations—and this should happen because of the snowball effect described above—the supply of corruption, and hence, its occurrence should decrease.

## **2.5 TESTABLE HYPOTHESES**

One can easily generate a set of testable hypotheses from the modeled interaction between business, bureaucracy, and associations. These can be grouped into testable propositions about static and dynamic effects. Hypotheses 1, 2, 3, and 4 (stated below) reflect the static model predictions, while Hypotheses 5 and 6 address over-time dynamics.

On the static side, if the model adequately captures reality, it should be the case that, for any given firm, there should be a direct relationship between corruption and

organizational participation. This reflects the model prediction that under pervasive corruption (high  $b$ ), an organization should find it easier to attract members. Similarly, according to the formal model, higher probability ( $p$ ) and the costs ( $f$ ) for being prosecuted for bribery should be associated with greater propensity to join business organizations. Therefore, the first two testable propositions state:

*Hypothesis 1:* The more that corruption is characteristic of the firm's immediate environment, the greater the propensity for the firm to join a business association.

*Hypothesis 2:* Anti-corruption measures increase participation in associations. Firms that operate in a stricter anti-corruption environment should be more likely to organize. Higher levels of organizational membership should be observed in the countries with stricter anti-corruption measures.

Additionally, there should be an inverse relationship between the formation of associations and the rigidity of the regulatory environment. The model suggests that as the term  $c_r$ , reflecting the cost of regulations, goes up, organizations should lower their dues or provide more benefits to attract members. As the cost of regulatory compliance goes up, organizations should provide more benefits to attract members. Otherwise, associational membership would not be sufficient to provide regulatory relief. Under extensive regulation, firms find it more advantageous to resort to corruption; thus, associations have to work harder to make participation worthwhile. At the same time, on the firm level, more invasive regulatory regimes should provide greater stimuli for participation. This provides for a conflicting set of expectations. On the one hand, costly regulations make firms more likely to

seek organizational strategy. On the other, an invasive regulatory regime inflates the start-up cost for an organization and makes associational venues less available. Therefore:

*Hypothesis 3:* Firms experiencing relatively high regulatory pressures should exhibit greater propensity to organize.

*Hypothesis 4a:* In countries and industries characterized by extensive regulation, fewer business associations should form.

A variant of the same proposition:

*Hypothesis 4b:* Business associations operating in the more invasive regulatory regimes should provide greater benefits to their members.

Notice that Hypotheses 3 and 4a specify the opposite relationship between regulation and organizational dynamics. This reflects different expectations in respect to firms and associations. On a micro level the relationship between regulations and organizational strategy should be positive. On the aggregate level, however, the expected relationship is negative because restrictive regulations make it harder for associations to provide regulatory relief.

In addition to these static hypotheses, which reflect the direct implications from the model, two hypotheses can be derived from the dynamic extensions. The snowball effect in organizational dynamics discussed above suggests that the net benefits of joining associations increase with the addition of new members. Likewise, associations might be able to accumulate greater resources and provide more benefits as their membership base increases. The following hypothesis captures the snowball effect:

*Hypothesis 5:* Over time, the benefits of associational membership should increase.

As associations mature, they should be able to expand their resources and functions.

Lastly, the long-term implications of the declining demand for corruption are that the maturity of and increasing membership in associations should lead to the declining supply of corruption.

*Hypothesis 6:* As organizational membership increases over time, corruption should decline. Effects should be observed in different countries and industries.

It is worth pointing out at this point that these hypotheses operate at different levels of analysis. The unit of analysis for evaluating Hypotheses 1, 2, and 3 is a firm. Hypotheses 4a and 6 operate at the country level, while the unit of analysis for Hypotheses 4b and 5 is a business association.

## **2. 6 CONCLUSION**

This chapter presented a theoretical argument about the effects of the regulatory environment on the formation of post-communist business associations. Such an environment, in many post-communist countries, is characterized by extensive regulation as well as by low-level administrative corruption. Administrative corruption was analyzed as presenting opportunities and creating pitfalls for businesses in transitional countries. I offered a stylized model of interactions between firms, bureaucrats, and business associations. I modeled participation in business associations as firms' responses to the corrupt bureaucracy and intrusive regulatory regimes. In this analysis, firms organize to pool resources to invest in targeted regulatory relief.

The argument developed in this chapter traces the roots of bureaucratic corruption to the regulatory environment and to businesses' desire to reduce the cost of complying with state regulations. When corruption becomes wide-spread and bribery mounts, business interests become threatened. When state institutions fail to provide a fair, effective, and predictable regulatory environment but instead harbor predatory bureaucrats, a solution can be provided by business organizations. They present the legitimate means of selectively reducing the cost of regulations and bypassing corruption.

Organizations can reduce the costs of regulatory compliance by either undermining the bureaucratic monopoly on regulation or challenging the rationality of regulatory practices. The former might appear in the form of self-regulation by industry associations that call into question the necessity of elaborate state regulatory mechanisms and might create better incentives for compliance. The latter can be done by employing legal expertise, litigations against state institutions, and other means that are usually too expensive for a single firm. The creation of organizations representing the interests of businesses in a particular region or industry offers additional channels for advocating the cause of regional or sectoral development and adds legitimacy to the demands for reduced regulation. Overall, by pooling their resources, organized firms can better fight costly regulations by increasing public awareness, appealing to the higher authorities, or employing legal protection.

The strategic interaction between firms, bureaucrats, and associations modeled above offers a new approach for conceptualizing the effect of state regulatory institutions on collective action of businesses. State regulatory regimes, bureaucratic probity, and functions performed by associations appear as important pieces of the emerging explanation for organizational formation. Building from a limited set of assumptions about firms' interest vis-à-vis state regulatory regimes, the model arrived at conclusions linking associational formation to regulatory regimes, the extent of corruption, and anti-corruption measures. The

model predicts that, other things being equal, business associations should find it easier to organize in the settings marked by higher degrees of corruption and more effective anti-corruption measures. Another prediction is that more intrusive regulatory regimes, in fact, make it harder for associations to emerge. Because business associations provide protective services selectively to their members, the model does not imply an immediate economy-wide corruption reduction. Rather, it suggests that in highly corrupt regimes, business associations can more easily extend their protective services to the members most exposed to corruption. In the long run, however, the development of business associations and increasing membership rates reduce the demand for corruption, making bribery less prevalent. The model also predicts that once an association is established, its membership should grow over time.

It is important to reiterate that the argument about the influence of corruption on the formation of business associations addresses low-level bureaucratic corruption. Entirely different dynamics can be observed if one considers other types of corruption involving higher-level civil servants and politicians. In my analysis, corruption operates at the rule-implementation level where public servants can withhold enforcement of regulations in exchange for unofficial payments. At the higher levels, the development of rules and regulations favoring special interests is likely to become the center of corrupt practices. This is likely to alter incentives on the part of businessmen, politicians, and bureaucrats and lead to different consequences for business associations.

The success of the organizational strategy outlined above depends on simultaneous actions of many individual firms and might become a subject of the collective action problem. This problem is bypassed when organizations are able to provide concentrated private benefits to their dues-paying members, so the reduction of regulatory costs is internalized by the firms participating in organizations. In this formulation, the formation of

business associations ceases to be the collective action problem. As the initial problem of organization is solved through the selective benefit provision, opportunities for truly collective benefits may arise. Individually, firms do not have the bargaining power to change the cost of regulatory compliance or bribes. However, as a group, firms might get greater leverage over state rules, regulations, and enforcement mechanisms. If they are able to organize collective action, they can act as an interest group, legitimately demanding industry- or economy-wide benefits.

Based on the predictions derived from the formal model, this chapter identified five testable propositions to be evaluated against empirical evidence from the post-communist countries. These operate at the different units of analysis and will be evaluated against quantitative data in Chapter 4. The quantitative analysis will address the propositions about the effects of bureaucratic corruption, anti-corruption measures, and regulatory environment on membership in business associations as well as implications for the associational dynamics. Chapter 5 will discuss how post-communist business associations are able to provide benefits exclusively (or cost-effectively) to their members. It will be demonstrated empirically that the functions and activities of voluntary business associations developed in the post-communist countries include various particularistic benefits associated with the reduction of regulatory burden. These have been of important value to associations' members.

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