EVOLVING DEMAND FOR INSTITUTIONS IN TRANSITION ECONOMIES

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1. Introduction

Modern views of factors of economic development and growth put institutions ahead of conventional production inputs. Institutions predicate the ability of a nation to efficiently utilize its own resources and attract those available globally. The quality of economic institutions exhibits broad variations worldwide, which in large part explains the observed dramatic differences in economic performance and welfare around the globe.

Institutions also vary over time, and their evolution reflects technological changes, market conditions, social and political transformations. The classical view of such evolution (see e.g. Knight, 1992) holds that institutions follow economic fundamentals to allow a society to capture efficiency gains that would not be available under an obsolete or otherwise inferior institutional regime. In other words, institutional changes are driven by social *demand* for efficiency-enhancing rules of the game. An equally important factor is the ability of the society to materialize this demand by *supplying* the required institutions in the form of laws, regulations, customs, conventions, etc.

In the early 1990s it was broadly expected that basic economic reforms in transition countries, such as liberalization and privatization, should create strong demand for efficiency-enhancing institutions, such as protection of property rights and enforcement of contracts, that would augment the emerging markets. Once economic agents realize that such institutions would serve their interests, they would either press the government for necessary legislative actions, or establish these institutions at the grassroots by means of self-regulation.

Such approach could be illustrated by the spontaneous model of establishment of private property rights (Boycko et al., 1995). According to the model, legal and regulatory mechanisms that effectively secure private ownership would emerge spontaneously, once economic resources and assets are passed into private hands, as it would be in the best interests of private owners to see such institutions in place. Economically empowered private owners were expected to use their clout to make government act, and would lead

the law-making process to an efficient outcome. Obstacles, if any, to this demand-driven process could be expected only on the *supply* side, where opportunistic bureaucracy could capture and arrest the institutional reform.

Indeed, political pathologies were common to all virtually all transition nations, where the development of market-augmenting institutions was usually lagging behind economic liberalization and privatization (Transition Report, 2000). However, some post-communist countries were able to catch up on their institutional reform, whereas elsewhere, including Russia, the delay became chronic and continued throughout the 1990s. This could be explained by a combination of factors on the supply *and* demand sides, i.e. by the inability of the state and self-organized communities to meet the demand for better institutions, or by the fact that such demand was suppressed or missed altogether, at least among the stakeholders that controlled the political process.

In Russia a lack of progress in economic reforms until the 1998 crisis was commonly explained by a deficit of political will, capture of the state by narrow interests opposed to a competitive market economy, and other supply side factors and phenomena. Likewise, the recent acceleration of economic reforms is often ascribed to political consolidation and commitment of the government to building market-augmenting institutions and implementing delayed structural transformations. However, a more careful analysis reveals profound changes on the demand side as well. It appears that demand for a law-based economy evolved over the course of transition – it was initially weak, and grew stronger over time. This paper offers several interrelated explanations of such evolution, and points out at obstacles to meeting the enhanced demand for efficient institutions. The paper is based in large part on a strand of research of institutional dynamics in transition economies implemented in 1996-2000 within the GET Program at the New Economic School. The analysis is illustrated by the Russian economic and institutional transition.

2. What retards the demand for efficient institutions?

In the early-to-mid 1990s the demand for a rule-based market economy in Russia was weak: neither the emerging large corporations, controlled by the "oligarchs", nor the traditional sector of formerly state-owned manufacturing enterprises, nor the nascent small businesses were champions and active proponents of secured private ownership, third-party contract enforcement, protection of investor rights and other similar institutions standard for developed market economies.

Oligarchs' opposition to secured property rights. One could expect that the institution of private ownership would be of paramount importance for financial and industrial conglomerates that had gained control over the "crown jewels" of the Russian economy and therefore would welcome and indeed demand effective public protection of property rights over privately owner assets. However, despite of the unprecedented political influence wielded by "big money" in Russia, insecurity of private ownership was and largely remains a major flaw in the Russian institutional setup. Demand for effective

protection and enforcement of property rights was conspicuously absent from the "wish lists" of Russian "kingmakers".

An explanation of this phenomenon, not anticipated by the advocates of the scenario of "spontaneous" post-privatization emergence of property rights, is offered in (Polishchuk, Savvateev, 2000). The paper argues that if the quality of public protection of property rights is a policy variable, then preferences of market agents over the range of such variable balance two consideration: first, protection of the agent's *own* assets, which is of course welcomed, and second, protection of holdings of others, which raises the cost of appropriation of resources and wealth by extra-market means. It could be expected therefore that at least some of the agents might opt for imperfectly protected property rights, which would maintain a desired balance between market production and appropriation, depending on the returns to these activities. The factors that could tilt this balance away from secured property rights are production inefficiency and inequality in asset ownership. If the returns to scale in production is steeply diminishing, then wealthier agents could rationally prefer to have opportunities to invest a portion of their resources into higher-yield appropriation – hence the production inefficiency caveat. If the resources are distributed evenly or near evenly, then an increase in *aggregate* wealth due to establishment of secured property rights would be a Pareto improvement and thus hailed by all agents. If inequality of resource ownership is more pronounced, this is not necessarily the case – hence the distributional qualification.

It is shown in (Polishchuk, Savvatteev, 2000), that indeed technological efficiency rules out opposition to secured property rights, whereas inefficiency of production technologies makes such seemingly perverse attitude of private owners to secured property rights possible. This possibility becomes an eventuality if the distribution of property rights is highly uneven. Both of these conditions were met in post-communist Russia, and the paper's predictions conform with the observed absence of support to public protection of property rights from the Russia's nouveau riches . It is noteworthy that opposition to secured property rights was centered at the wealthiest segment of the society – normally threat to private property is expected from the poor.

Low support to efficient corporate governance in the traditional sector. Managers and other insiders of formerly state-owned firms were steadfastly opposed to transparent corporate governance procedures, as they would have restricted opportunities for asset-stripping and other types of abuse of the agency relationship. Those employed in the traditional sector of the economy were apprehensive of restructuring, inevitable if sound corporate governance rules are introduced and enforced, and losses of employment and income that such restructuring would have entailed (Polterovich, 1992).

Small businesses showed little interest in influencing official rules. At the early stages of Russia's post-communist transition small firms operated primarily in services and trade – sectors of the economy which are less sensitive to the quality of the institutional environment (see e.g. Polishchuk, 2000a). Initially operations of small businesses were conducted primarily on spot markets and did not require significant production assets ownership over which had to be protected. Simplicity of contracts and "lightness" of

business activities limited the need of small businesses in protection of property rights and third party contract enforcement. Multiple unfilled market niches and broad opportunities for arbitrage after economic liberalization made small firms by and large content with an economy lacking market-augmenting institutions, and in the early 1990s Russian small businesses grew rapidly despite of the institutional lacunae. Small business advocacy aimed at improving government policies was practically absent: according to (Radaev, 1998), Russian small and medium firms en masse refrained from attempts to influence legislation, regulations and other institutions of the official sector of the Russian economy.

The society was reluctant to endorse the new allocation of resources, wealth, and economic roles that emerged chaotically and left vast majorities economically disenfranchised (Polishchuk, 2000b). Demanding or even acceding to publicly provided protection of property rights would have been tantamount to endorsement of the new economic order that many in the society viewed as unjust and robbing people of their basic economic rights. Low legitimacy of the property rights regime and a lingering threat of a major redress sparked massive capital flight and frustrated the expectation that privatization would stimulate an economic recovery, thus making population more content with the transition outcome.

The above factors suppressed in the early and mid-1990s the demand for rule of law across the Russian society and economy. It is symptomatic that legal reform and other ways to supply market-augmenting institutions were barely noticeable on the reform agenda of the that period. In the meantime the vacuum left by missed rule of law was filled by various institutional surrogates (Kapeliushnikov, 2001), the "natural law", based on informal conventions, patterns of contract, and means of conflict resolution. Some of these surrogates were nested in the "business culture" inherited from the Soviet time. A lack of experience of reliance on law to further firms' interests was, according to Hendley (1999), another reason for weak demand of rule of law in the Russian economy. A related argument (Hay et al., 1996; see also Posner, 1998) holds that a poor country cannot afford a sophisticated legal system and should look instead for less expensive palliatives, such as enactment of "efficient rules for the existing inefficient institutions to administer". Arguably formal law based on an official legal system is more efficient than the natural one (this is also seen from a body of empirical evidence (Barro, 1991, Scully, 1988)), but the latter comes free, whereas the former is provided and enforced by the government and therefore entails costs necessary to support the officialdom and comply with state-imposed requirements and constraints, not to mention the opportunities to abuse government's law-making and law-enforcing prerogatives.

3. Emergence of demand for rule of law

Over time, and in particular since the 1998 crisis, the demand for enforceable rule of law in the Russian economy grew stronger. This can be seen from the recent polls of managers and owners of Russian firms – these surveys reveal an increased interest of

market agents in a transparent, stable and effective legal framework, their growing willingness to transfer operations from the shadow economy into the formal sector, readiness to pay in full reasonable taxes in exchange for public protection of property rights, law and order, etc. (Gurova et al., 1999; Cadwell, Polishchuk, 2001; Yakovlev et al., 2002). The business community shows a growing capacity for self-organization in pursuit of collective interests, and an increasing number of business associations are involved in advocacy efforts to influence the ongoing legal and regulatory reforms. The idea of reaching a "social contract" between the government and private sector is gaining popularity (Auzan, Kriuchkova, 2002); such contract is expected to outline mutually agreed rules of conduct for government and businesses, and include commitments to follow such rules. Firms pledge their compliance with codes of good corporate governance (Guriev et al, 2002; Yakovlev et al., 2002), and some of them adopt transparency standards which go beyond what is mandated by the current legislation. Signaling the willingness to operate according to official rules through increased transparency is particularly noteworthy, as such signaling is costly for firm insiders – both in terms of direct costs and missed opportunities to manipulate corporate reports and accounts – and thus is more credible than declaratory statements.

Russian firms are more actively resorting to courts for resolution of commercial disputes, instead of resorting to informal means and private "protection services" prevalent in the recent past. Court statistics underestimates the actual relevance of courts: according to Yakovelv et al. (2002), the prospect of filing a law suit often prompts the parties to settle out of court. Another evidence of increased importance (if not appreciation) of law in the Russian private sector is broad and growing awareness of Russian firms of existing legislation, use of services of legal experts, databases and other sources of legal information. Finally, a telling indicator of the support in the society of the idea of law and order is the unprecedented popularity of President Putin who has proclaimed strengthening legal foundations of the economy and society as his political priority.

Demand for the rule of law in Russian emerged at a time when the "natural law" became insufficient to adequately support economic transactions, which grew in their scope, scale, and complexity. The observed surge of demand for rule of law is an outcome of several factors and processes. The changes in the economy and society that prompted this increase have been mounting throughout the 1990s, and/or triggered off by the 1998 crisis.

Tragedy of the commons. With most of the economy put under private control, large financial-industrial conglomerates started crowding out each other in their unrestricted contest for economic resources, production facilities, and sources of rent. In a situation with "nothing left to steal" (Aslund, 1999) such contest becomes counterproductive, which makes its participants seeking coordinating constraints that would establish mutually acceptable rules of conduct and uphold the status quo. Smaller businesses that had secured market niches, invested in physical and human capital, etc., had a similar need in protecting their assets. Without such protection market agents started suffering growing losses typical for the "tragedy of the commons", i.e. a situation of unrestricted access to limited production resources. Tragedy of the commons could be averted by an

introduction of secured property rights increasing efficiency of resource use and under certain conditions benefiting all the users. Economic history provides numerous examples, when a tragedy of the commons was a catalyst of institutional change leading to secured property rights (see e.g. Libecap, 1989, Eggerston, 1990, Ostrom et al., 1994), and the recent Russian development conforms with this pattern.

Utilization of pre-existing capacities and need for investments. The dramatic devaluation of the ruble in the aftermath of the 1998 crisis created competitive advantages for the heretofore stagnant Russian economy. The economic growth that ensued had put in use the previously idle production capacities, and, to be continued, required investments into physical capital. Investments are examples of economic transactions extended over periods of time, and require more reliable and sophisticated institutional foundations than the surrogates that were sufficient for a primitive "spot market" economy. Under such conditions an institutional bias in favor of simultaneous exchanges against more complex transactions becomes very costly (Hendley et al., 1997) which naturally leads to a stronger demand for formal rule of law. Two factors are at work here: first, investments require predictability of the rules of the game for a period of time, which can be assured by a credible rule of law, and second, outside investors cannot directly control the use of their resources and have to rely on publicly provided institutions of property and contracts (North, 1990). Either way, an increased need for investments boosts demand for such institutions.

Concerns over the investment reputation of the nation on the global capital market. The crisis has dramatically devalued the domestic production assets and hence raised the importance for the Russian economy of global investment resources. Raising venture capital abroad – both through foreign investments proper, and through prevention of own capitals' flight – requires an improved investment climate. An increased dependency on international capital strengthens demand for the rule of law that would serve as a commitment devise for foreign investors. This affects incentives of policy-makers, making them less likely to renege on investment guarantees offered to foreigners, and uphold the rule of uniformly and impartially.

Indeed, according to (Polishchuk, 2000c), foreign investments are not fully secure even under a benevolent democratic government concerned about the wealth of citizenry. On the one hand, such a government has a strong incentive to establish necessary legal foundations for value-adding economic transactions. However, this argument applies only to contracts between *resident* economic agents, when gains from contracting are internalized within the jurisdiction represented by the government. When contracts involve *outsiders*, their inviolability is not any more unconditionally desirable for the jurisdiction in question, because the rights of an outside party could be violated to benefit residents. For example, the government could expropriate the returns to invested capital, which accrue to outside investors, and re-distribute those returns to residents. Of course, such violation would not be costless, as it would damage the reputation of the nation or locality, and stop the inflow of investments in the future. However, the presence of counteracting arguments for and against violation of rights of outside investors means that selection of a good investment climate is in fact a *policy tradeoff*, which in principle

could be resolved in various ways. A decrease of value of domestically owned production assets tilts this tradeoff in favor of protection of property and contract rights of residents and foreigners alike, as the relative cost of retaliatory abandonment of the national economy grows bigger. By protecting outsiders' rights the government thus responds to *domestic* demand for universally applicable rule of law.

Demand for corporate transparency standards. Greater corporate transparency prevents insiders from appropriating profits due to outside shareholders under the guise of ostensibly low gross revenues due to "unfavorable" market conditions. When transparency is low, outsiders have to incur significant, at times prohibitively high, costs to verify such claims and could rationally elect to take them at their face value. While opportunistic insiders would welcome the opportunity to gain at the outsiders' expense, they would be penalized by a reduced level of outside investments, as investors, kept under the "veil of ignorance", factor in the risk of appropriation of their dividends. It can be shown that if transparency standards of a firm are costlessly observable by risk-neutral investors which have access to alternative investment opportunities yielding a market rate of return, then the cost of incomplete transparency to insiders outweighs benefits, and hence full transparency ensues.

Suppose, however, that an economy has a reputation for low transparency standards, and, reflecting this, the gross stock of outside investments into the economy is low. If an individual firm wants to raise its transparency standards in order to attract additional investments, it has to overcome the negative collective reputation by signaling individually its adherence to higher standards. Such signaling is costly, and a small firm might not be able to recoup its cost, payable by insiders, from increased revenues. Big firms are faced with a problem of different sort – they would be constrained by the overall limited stock of investment capital earmarked for the economy at large, and thus would not be able to get a sufficient reward by outside investors for increased transparency. Therefore neither large nor small businesses might have the necessary incentives to improve transparency unilaterally, sustaining the negative investment reputation of the economy.

Unlocking such low-level equilibrium requires collective actions to establish high transparency standards economy-wide, either legislatively or by way of self-regulation. The recognized need for such actions is another factor of the demand for rule of law.

Consolidation of the state. Yearning for law and order after the years of chaotic and largely spontaneous reform created favorable conditions for consolidation of the state. A government which is committed to establishing the rule of law in Russia is enjoying strong support in the society. Broadly based *expectations* of enactment and enforcement of laws that would form a solid legal foundation for the Russian economy have become an important political reality. The impetus for legal reform at present is coming from the society, which is in sharp contrast with the past practices when such reforms were initiated by the government and a narrow circle of political elites. One could expect that once the economy and society have matured to demand the rule of law, and a

strengthened government is prepared to meet such demand, the necessary legislative action would ensue promptly.

The reality has only in part confirmed such expectations. Despite of the favorable conditions, the progress in legal reform in such critically important directions as banking, pensions, natural monopolies, corporate governance, labor, intergovernmental relations, etc. is lagging behind the existing urgent needs. It is symptomatic that court reform which was expected to increase the efficiency of the Russian legal system, encountered serious problems in its implementation and experienced long delays.

4. Obstacles to legal reform

The phenomenon of delayed reform is well-known in modern political economy (see e.g. Drazen, 2000) and has various explanations. Most theories link delays to political conflicts over distribution of reforms' gains and losses. In the case of legal reform such conflict is exacerbated by the concentration of efforts on *law-making.* Paradoxically, the observed delay is in large part due to the very fact of strengthening of the state and preparedness of the society to comply with officially established rules. Broadly shared expectations of radical legal reform, anticipated stability of new laws, and the ability of the state to enforce them have strongly affected political preferences of main stakeholders, as well as influence activities. In the "natural law" environment such activities targeted *current* decisions of the government, on the eve of major legal efforts the focus of lobbying has naturally shifted onto *law-making* itself.

This shift has dramatically raised stakes in advocacy, as the subject of contest are not one-time payoffs, but gains and losses which are *capitalized* over the long period of time when the law remains in effect. Higher stakes lead to greater investments of resources into lobbying and thus make the political conflict more acute. By the same token, those extracting rent from legal lacunae of a partially reformed economy are resisting the legal reform or trying to reduce its scope.

In addition to increased intensity of lobbying, a prospect of legal reform boosts formation of politically organized interest groups representing potentially affected constituencies. Prevalent in the 1990s was individual lobbying for exclusive benefits – according to Radaev (1998), Russian managers and business owners, instead of organized collective efforts, preferred to use their personal connections in the quarters of power. At present corporative lobbying is more common: due to its universality, a law benefits or harms in the same way *groups* of economic agents, and the commonality of interests within such groups prompts their self-organization and subsequent collective actions. This increases investments in lobbying and raises political tension even further.

Paralyzing political conflict over legal reform is less likely if the new laws are *public,* in that they are expected to release broad efficiency gains by cutting production and transaction costs, and are otherwise distributionally neutral. However, in practice laws

could be *private*, in which case they advance interests of particular groups at the expense of the rest of the society. While such laws could still increase aggregate efficiency, they are not necessarily expected to do so – their main objective is to benefit selected constituencies, not the general public, and this can be accomplished even if aggregate efficiency suffers.

If a newly established legal regime could include private laws, its broad support in the society is no longer assured. This reduces attractiveness of the idea of the rule of law, even if the necessary economic prerequisites are met, because of the concern that the new order could be biased, and a "seat" in the exclusive group of winners is not guaranteed and/or is costly to obtain. In this case the "natural law", although potentially less efficient than an appropriately crafted official public law, could still be a preferred option to a legal reform with a private law-based outcome.

These apprehensions could deter legal reform in at least two possible ways. First, the ex post bias of the private law could be unpredictable ex ante, and a given agent or group cannot be certain whether they'll belong to the coalition of winners, or will be left out among the losers. Such uncertainty could make risk-averse agents to prefer the risk-free status quo, even if the expected welfare of an agent after the legal reform is higher, than prior to the reform. This is an example of the general phenomenon known as the *status quo bias* (Drazen, 2000), which causes delays of efficiency-enhancing reforms. The status quo bias becomes even stronger if private laws make aggregate efficiency gains to dissipate partly or in full.

While the status quo bias explains delay of legal reform by risk aversion, another explanation invokes aforementioned influence activities aimed at securing favorable private laws and/or preventing enactment of private laws that would be unfavorable. Establishment of the official rule of law subjects economic activities and transactions to government decisions that will be politically motivated and driven. The prospect of dependency on such decisions raises two possible concerns.

First, some agents could fear that they are a priory disadvantaged in efforts to secure favorable legislation, and therefore would be denied the benefits of the rule of law, which are expected to be captured by others, better enabled to influence government decisions. Potential disadvantages in influence activities include insufficiency of resources that could be invested into shaping government policies, lack of channels to communicate with the authorities, and, importantly, low ability for political organization. It is conceivable that a failure to effectively promote one's interests could lead not only to a denial of benefits of an official rule of law, but even to net losses in comparison with the "natural law" after an official rule of law is enacted. Indeed, with introduction of an official law resources and value-creating activities that were earlier shielded in the informal sector from government taking, become exposed to government policies which could be hostile to particular agents. As a result, agents who are skeptical about their ability to influence government decisions, become opposed to a rule-of-law oriented reform, even when economic fundamentals favor such reform.

Another reason for apprehension about the rule of law is the cost of influence activities that an advent of legal reform is likely to entail. Even those who are well-positioned in the forthcoming political contest over private laws, are concerned about the required resource expenditures in such contest. Costs of these resources will have to be added to the direct costs of compliance with the rule of law, such as taxes, reporting requirements, etc. As a result, the efficiency gains expected to be released by the new law could be eaten up by influence activities, making the official rule of law inferior to the "natural law" in the second-best setting. Moreover, influence activities could require resources beyond the increase of wealth created by the new law, in which case participating agents would end up being worse-off. The natural reaction to this prospect is to prevent such wasteful contest from happening, i.e. resist the introduction of the new law.

The above arguments suggest that the willingness and ability of the society to establish the rule of law is contingent upon the perceived pliancy of the government to political influence. If the government is credibly committed to respond to grassroots demand for the rule of law by public laws, then economic prerequisites of the rule of law promptly materialize in a legal reform. The necessary commitment could be ensured constitutionally, if the constitution effectively restricts government to legislative activities solely in the public law domain, and prohibits private law-type legislation and policies. Apart from de jure promulgated constitutional safeguards, an important precondition of the rule of law is appreciation in the society of constitutional checks and balances, and henceforth de facto compliance with them. Of particular significance for the rule of law is the rejection of political transactions whereby the government re-distributes wealth away from some constituencies to others, to win the latters' support (Weingast, 1997). Such constitutional tradition and culture is obviously missed in Russia.

5. A menu auction analysis

Political influence over legal reform was investigated in (Polishchuk, 2001) by means of menu auction analysis (Bernheim, Whinston, 1986; Grossman, Helpman, 1994). The analysis follows the logic of Buchanan (1987), when a policy process is viewed as consisting of two stages. At the first stage basic policy-making rules, such as constitution, are set, and at the second stage policy making takes place according to pre-set rules. In this framework constitutional design should lead to a subgame-perfect Nash equilibrium, whereby rules are selected to optimize the outcome of the policy game played once the first stage rules are in place. Buchanan assumes that at the first stage special interests have not been formed yet, which allows to set rules which serve broad (encompassing) public interests by restricting special interests hereafter.

The approach in (Polishchuk, 2001) employs a similar logic with two important modifications. First, it is assumed that at the initial stage no *specific* rules are set, but instead the society has to accept or reject the rule of law as a general principle, leaving specifics of the legal framework that would ensue to be decided at some later time.

Second, we assume that such decisions are made when the society is not a political *tabula rasa*, and at least some special interests are already well established and organized.

Accordingly, emergence of the rule of law could be viewed as a three-stage game. At the first stage agents agree or disagree individually to subject the economy to the rule of law. If the rule of law gets necessary public support (e.g. is favored by a majority, or, depending on political institutions, otherwise endorsed by a decisive constituency), it is established; otherwise the economy stays with the "natural law", and the game ends. In case the rule of law has been supported, at the second stage agents engage in influence activities, aiming to secure favorable legal arrangements. At the third stage, the government enacts specific laws and rules, responding to grassroots influence.

Of interest in this game are subgame-perfect Nash equilibria, where establishment or rejection of rule of law depends on anticipated payoffs, and the latter, in their turn, are affected by political influence. An analysis of such equilibria reveals links between the emergence of rule of law, on the one hand, and political culture, constitutional constraints, fiscal and regulatory tools available to the government, and grassroots capacity for political organization, on the other. This analysis summarizes as follows.

If the government is expected to be highly opportunistic (i.e. receptive to lobbies' contributions), then unorganized agents could become worse-off under a newly established legal regime, even if the economic prerequisites for the rule of law are met. Such agents are particularly vulnerable when the government has access to efficient wealth redistribution tools, such as broadly based taxes with little or no deadweight losses. If so, the unorganized part of the society is naturally opposed to the rule of law, and when unorganized agents form a majority, democratic endorsement of the rule of law is unlikely.

It is further shown that the attitude of organized interests to the rule of law depends on the structure of the market for lobbying. When a lobby has a monopoly over political influence, it secures additional gains on the top of those available when the law serves public interests and is unbiased. However, competition among lobbies for political influence erodes their gains and could eat up all the benefits of the rule of law, and even leave politically organized groups worse-off than without the rule of law. Again, such losses are particularly profound when the government could deploy efficient taxes to re-distribute wealth or threaten such redistribution to extort political contributions from lobbies. The bigger is a lobby, the better it is protected from such political blackmail.

A menu auction analysis of legal reform shows that establishment of the rule of law has better chances if the society is sufficiently politically organized and yet not fractionalized. Otherwise the rule of law could be established on a constitutional basis that restricts political influence and opportunities of the government to re-distribute wealth in response to pressure of narrow interests.

6. Legal reform and representative democracy

Influence activities have slowed down legal reform in Russia. A few accomplishments up to date, and most notably the new Tax Code, required lengthy and costly coalition-building, painstaking bargaining, and mobilization and concentration of political resources available to the government (Gaidar, 2001; see also Cadwell, Polishchuk, 2001, from where the analysis in this section is drawn). High costs of such mobilization quickly use up the political potential of the executive branch which has to concentrate its efforts on a limited number of top priority directions. Neither president's high popularity nor a comfortable parliamentary majority were sufficient to ease political constraints over the legal reform.

The present emphasis on strengthening "vertical power" in Russia, which is expected to enhance the efficiency and consolidation of the government, is not necessarily instrumental in breaking the gridlock. A comparative study (Keefer, 200) shows that with insufficient checks and balances lobbying is more intense, because interest groups have full confidence in the ability of the government to implement a particular policy, and this certainty increases investments into influence activities. In reality the omnipotence of the government turns out to be illusory, because counteracting and countervailing pressure of organized interest groups paralyses policy process. Moreover, the executive branch of power ceases to be monolithic, and its departments and agencies become channels of political influence, and substitute political factions in policy debates. (Yakovlev et al. (2002) points out to the growing role of "regulators" in the Russian legal reform).

Therefore a seemingly winning combination of the commitment of Russia's top leadership to the principles of liberal law-based economy, of the conformity of such policy platform with the interests of broad grassroots constituencies, and of the trust and support of the president within the society, is still insufficient for prompt implementation of the broad reform agenda. The obstacles are mostly political, due to immaturity of representative democracy in Russia.

According to (Transition Report, 2000), political and economic competition in the post-communist world are strongly correlated with each other. Political contestability and public participation in policy debates increase accountability of the executive and legislative branches, bring to the open policy conflicts and dilemmas, and put obstacles to narrow interests' capture of policy processes. This suggests that a key to successful legal reform in Russia is in development of multi-party democracy and civil society, in transparency of policy reform process, and in institutionalized practice of public-private dialog.

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