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Dinissa Duvanova: Building business in post-communist Russia, Eastern Europe, and Eurasia: collective goods, selective incentives, and predatory states

By: Dalibor Rohac – October 17, 2013

Why do business associations exist? Adam Smith's canonical answer was that "[p]eople of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices" (Smith [1776] 1981, p. 145) Following Smith, public choice scholars tend to interpret the existence of business associations as institutionalized attempts at rent-seeking. However, according to Dinissa Duvanova's book, *Building Business in Post-Communist Russia, Eastern Europe, and Eurasia*, that is not the only possible reason for their existence.

A casual inspection of data from transitional countries of Eastern Europe reveals a paradox. Transitional countries with the most vibrant civil societies and strong democratic governance were *not* the ones with the most intense activities by business associations. Instead, countries like Russia or Ukraine—with very low levels of civil society activism—experienced unparalleled booms in the numbers of business organizations and in their participation rates. The explanation for this phenomenon, according to Duvanova's book, is that business associations in Eastern Europe have emerged to help their members tackle adverse business environments. While still being driven by 'special interests', their goal was not to plead for special privileges but rather to respond to—and to protect their members from—bureaucratic corruption. Because of free riding, few business associations succeeded in lobbying for deregulation or the creation of a predictable legal environment. Instead of lobbying, business associations thus focused on providing excludable services to their members—namely by assisting with regulatory compliance.

The book starts by outlining a simple theoretical framework that models the interaction of bureaucrats, firms, and business organizations in business environments characterized by intrusive regulation. Bureaucrats have the choice between being honest or corrupt. In the latter case they can also choose the level of bribes they request for overlooking regulatory violations. The firm chooses, based on the costs it faces, between complying with the existing regulations on its own, bribing the bureaucrat, or joining a business organization that can assist the firm with regulatory compliance. In turn, the business organization decides on the level of dues and the amount of regulatory relief it produces for its members. Obviously, under effective anti-corruption policies, firms will be disinclined to bribe and will rather seek regulatory relief through business associations. However, not all predictions of the model are as straightforward. When regulation is extensive or far reaching, it becomes more difficult for business associations to provide cost-effective regulatory relief. At the same time, it becomes more attractive for firms to look for ways around regulation, either through corruption or collective action.

Other things being equal, the higher the cost of regulatory compliance, the lower the propensity of firms to form and join business associations. Simultaneously, the higher the cost of regulatory compliance, the larger the benefits that business associations need to provide to their members in order to steer them away from corrupting bureaucrats. In other words, business associations will flourish most in environments where the costs of regulatory compliance are not steep, but rather where there is a lot of leeway to interpret rules or enforce them in a lax way. Another prediction, derived with a few auxiliary assumptions, is that business associations will display snowball effects. As they gain more members and more experience in providing regulatory relief, they can be expected to become the preferable method of regulatory relief, instead of bribery.

To test these predictions, Duvanova proceeds in two ways. First, she presents case studies of business association activities in Russia, Ukraine, Kazakhstan, and Croatia. Although these do not provide a rigorous testing ground for the fairly nuanced predictions of the model, they seem to rule out the common explanation for business associations as special interests aiming to capture policy. Only rarely, for instance, does one see active business associations in sectors associated with powerful economic interests. Even in the presence of compulsory membership—typically associated with state-sanctioned business chambers where direct lobbying or regulatory capture can be expected—firms tend to develop organizations that represent alternatives to the official chambers, most of them organized around a specific sector or region.

Secondly, the book provides quantitative evidence from a 1999 survey of companies operating in post-communist economies. The use of firm-level data to test whether reported levels of regulatory burden are related to membership in business associations presents a potential endogeneity problem. This is because firms' perceptions of the regulatory burden are related to the regulatory relief they can find, either through collective action or through corruption. To address the issue, the book relies on aggregate measures of the costs of regulatory compliance, which can be expected to be independent of regulatory relief at the level of individual firms. The basic finding is that the burden of regulation is inversely related to membership in business associations.

To test the effect of corruption on membership, the book relies on firm-level measures of the rule of law and bribery. Finally, to test the notion that lax enforcement of rules encourages membership, a multiplicative interaction term between regulatory procedures and public oversight is constructed. While the empirical work in the book has been done with care, one wonders whether the available data allow for unambiguous tests of rather subtle hypotheses. It is not clear, for example, that the used measure of laxness of regulatory enforcement truly captures the extent to which bureaucrats enjoy discretion in enforcing rules.

Similarly, the instruments used for bribery—the clarity and consistency of rules and the percentage of managerial time spent in ensuring regulatory compliance—are not entirely convincing as it is conceivable that such perception-based measures could have a direct effect on membership.

However, these quibbles should not be read as criticisms of Duvanova's work per se, but rather as general concerns about the way in which economists seek to test very specific claims using data that are by their nature rather coarse. However, if one had to point to one shortcoming of the book, it would be its failure to explicitly connect its findings to the literature on polycentric orders and polycentric governance (see, for instance, McGinnis 2000).
But even without making the connection explicit, Duvanova deserves credit for shifting the focus of the discussion on the nature of collective goods provided by business associations and for their organizational mechanisms—much in line with this body of research.

The book should be seen as an important contribution to the field. Besides the material outlined above, it provides evidence for its prediction that business associations gain strength over time, and also an interesting account of differences between associations with compulsory and voluntary membership. The bottom line? There is much more richness to the activities and motives behind the emergence of business associations in transitional economies than most public choice scholars would immediately think.

References

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