

**Impetus or Impediment: Market Power, Foreign Direct Investment and Judicial
Reform in Russia and Kazakhstan**

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**A dissertation
submitted in partial fulfillment of the
requirements for the degree of**

Doctor of Philosophy

University of Washington

2015

Reading Committee:

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Program Authorized to Offer Degree:

Political Science

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Abstract

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Demand for law has been recognized as a necessary component of successful legal reform programs. However, the causal variables that support demand for law remain unclear. This dissertation hypothesizes a relationship between the structure of national economies and the demand for law, contending that a strong small and medium sized enterprise sector is necessary for legal demand to develop. Explored through the cases of Russia and Kazakhstan and their respective systems of economic courts, this dissertation depicts how in an economy with a strong SME sector legal demand grows, while in states in which the economy is highly concentrated among a few large firms the concomitant development of the SME sector and ultimately the demand for law is considerably weaker. The final component of this dissertation examines the differential effects of foreign direct investment (FDI) on legal reform. When FDI is directed primarily towards large firms, it will support market concentration and undermine the demand for law. Conversely, FDI focused on the SME sector can serve to support increased in the demand for law.

Table of Contents

Chapter One:

Legal Demand, the Rule of Law, and Economic Development5

Chapter Two

The Political Economy of Legal Reform30

Chapter Three:

The Case of Kazakhstan58

Chapter Four:

The Case of Russia113

Chapter Five:

Conclusions132

Bibliography159

Chapter One:

Legal Demand, the Rule of Law, and Economic Development

“The absence of contract enforcement mechanisms is the most important source of both historical stagnation and contemporary underdevelopment in the Third World.”

- Douglass North, *Institutions, Institutional Change, and Economic Performance*

Introduction: The Problem

The reform of legal institutions maintains an impressive and venerable historical pedigree. When the Roman jurist Tribonian revised the *Codex Theodisianus* and *Codex Grigorianus* to create the *Corpus Juris Civilis* in 529 C.E. for the Emperor Justinian, he had no way of knowing that this body of law would serve as the basis for the first western legal reform initiatives that took place across the regions of Europe during the medieval period. Scholars working in the area of comparative law have gone so far as to claim that subsequent to a regime’s decision to accept Tribonian’s *Corpus* “everything else (i.e., the successful development of civil law) followed naturally.”¹ Thirteen hundred years later, in the modern era, the strengthening of legal institutions became a hallmark of the economic development strategies of less developed states throughout Asia and Latin America. Ranging from the romping success of Meiji Japan’s adoption of the German commercial code in the late 19th century to the dismal failures of a

¹Alan Watson. 1981. *The Making of the Civil Law*. Cambridge: Harvard University Press, pp. 32-33.

multitude of constitutional reform projects in the Latin American states,² the results were anything but uniform.³

Nonetheless, the salience of legal reform would only increase for the developing world as post-war reformers worked to bring “modern legal culture” and (in later years) “the rule of law” to less developed countries (LDCs).⁴ After a half century of such measures, the results are viewed at as best inconsistent, and at worst as a dismal failure; the only point of agreement being the cost.⁵ Since 1990 the World Bank has supported 330 rule of law projects and spent almost \$3 billion to fund them.⁶ Nevertheless, regardless of the enormous problems encountered, legal reform continues to find itself at the center of both global development and foreign policies, made

²R.J. Kolesar. 1990. “North American Constitutionalism and Spanish America: A Special Lock Ordered by Catalogue, Which Arrived With the Wrong Instructions and No Keys?” in G. AthanBillias, ed., *American Constitutionalism Abroad*. New York: Greenwood Press. Robert C. Means. 1980. *Underdevelopment and the Development of Law*. Chapel Hill: University of North Carolina Press.

³ Meiji era Japan is regularly referred to as one of the paradigmatic cases of successful legal reform, noting its importation of the German civil code and the rather rapid adoption of this body of law on the part of the emerging Japanese industrial sector in the late 19th and early 20th centuries. Successful legal reform has been understood in this context as two-fold: (i) the presence of an efficient system for the adjudication of contractual disputes and (ii) the creation of a “monopoly of law” whereby pre-existing, traditional approaches to dispute resolution fell by the wayside and the utilization of the formal civil code became par for the course among Japanese economic actors. The training of the early Japanese bar in Germany and the importing of myriad German experts in order to build the judiciary has been extensively explored and has continued to serve as a model for legal reform programming by various multilateral and bilateral institutions. Alan Watson. 1974. *Legal Transplants: An Approach to Comparative Law*. Athens, GA: University of Georgia Press. Elliott J. Hahn. 1983. “An Overview of the Japanese Legal System,” in *Northwestern Journal of International Law and Business*, vol. 5:3. Holger Spamann. 2009.

“Contemporary Legal Transplants: Legal Families and the Diffusion of Corporate Law,” Discussion Paper 28, John M. Olin Center for Law, Economics and Business at Harvard University. John Owen Haley. 1991. *Authority without Power: Law and the Japanese Paradox*. New York: Oxford University Press

⁴David Kennedy. 2006. “The ‘Rule of Law,’ Political Choices, and Development Common Sense,” in David Trubek and Alvaro Santos *The New Law and Economic Development: A Critical Appraisal*.

⁵ William Easterly. 2014. *The Tyranny of Experts: Economics, Dictators, and the Forgotten Rights of the Poor*. New York: Basic Books. For a discussion of the failures in the post-socialist states, Cynthia Alkon. 2002. “Cookie Cutter Syndrome: Legal Reform Assistance under Post-Communist Democratization Programs,” in *Journal of Dispute Resolution*, vol 2002: 2, pp. 327-365.

⁶ World Bank. 2000-2009. *Initiatives in Justice Reform*, editions 1-6. Washington D.C.: World Bank.

manifest most recently by the Bush and Obama administrations' "post-war" legal assistance initiatives in Afghanistan and Iraq.⁷The outcomes, to even the most casual observer, must be judged as, at the very least, sub-optimal.

Despite even these fresh failures, the establishment of the rule of law, the protection of property rights, and the development of a legal system which is able to lower transaction costs for firms in a competitive globalized marketplace continue to be given pride of place in development policy. Moreover, as discussed in chapter two, these topics – particularly the challenges inherent in building the rule of law and understanding processes of institutional reform – are core topics for political science in general and political economy in particular. The question has even greater contemporary salience in light of the central role rule of law programming will play as one of the recently announced UNDP Sustainable Development Goals (SDGs).⁸ Similar to the earlier set of Millennium Development Goals, this initiative is intended to coordinate and harmonize development work across the globe. Through the SDGs, the UNDP will shepherd a significant share of public and private development funds towards legal reform initiatives over the next fifteen years. Thus, the question must be

⁷The contemporary policy relevance of this issue is depicted via the multiple, multi-million dollar projects which were implemented by USAID (<http://www.usaid.gov/iraq/activities.html>), the United Nations Assistance Mission for Iraq (<http://www.uniraq.org/docsmaps/undocuments.asp#RDUpdates>), and countless consultants and sub-contractors.

⁸ Louis-Alexandre Berg and Deval Desai. 2013. *Overview on the Rule of Law and Sustainable Development for the Global Dialogue on Rule of Law and the Post-2015 Development Agenda*. New York: UNDP. Stephan Haggard, Andrew MacIntyre, and Lydia Tiede. 2007. "The Rule of Law and Economic Development," in *Annual Review of Political Science*, vol. 11, pp. 205-34. Thomas Carothers. 1998. "The Rule of Law Revival," in *Foreign Affairs*, vol. 77:2, pp. 96-106.

asked: why have so many of these initiatives failed and what information is required in order to improve legal reform programming? The answers are to be found in the concepts of “supply of law” and “demand for law.”

Under-development is no longer understood as a result of geographic determinism or core-periphery transfers of wealth but as an outcome of deleterious institutional frameworks which are unable to resolve collective action problems and incentivize growth-enhancing individual action. Recognizing the central role of institutions in explaining development outcomes is essential. However, absent a sound theoretical framework grounded in valid empirical research, development interventions that aim at the reform of legal institutions risk repeating the same mistakes of the programs of earlier years, e.g., significant investments in the bar, the bench, the civil code, and infrastructure (the aforementioned “supply”) that end up sitting unused by the broader population (depicting an absence of demand). Alkon has noted the grim record of legal reform in post-socialist economies in particular. She highlights the failures of the so called “cookie cutter” approach that applies a similar, four pronged supply of law model to all states: re-writing of laws; training programs for legal professionals; technological assistance and the refurbishing courthouses; and institutional development.⁹ Experience has shown that a supply of law can be relatively

⁹Alkon 2002, p. 328.

easily provided through technical assistance and “Big Push”¹⁰ style investment in human and physical capital; however, this provision does not necessarily mean that “law on the books” will actually be taken up and utilized by individuals and firms.¹¹The causality behind the demand for law and clarity as to the conditions under which individuals and firms choose to utilize formal legal institutions in order to resolve disputes is still extremely vague. It is this question –the determination of the conditions which facilitate demand for law and those that undermine that demand–together with the recognition that the answer thereto is vital to avoiding the mistakes of that past that is at the center of this dissertation. A starting point for understanding the causality behind the demand for law is the broader economy and the relationship between economic development and the legal system.

With regard to the role of legal institutions, the current understanding contends that a formal legal system will facilitate greater predictability in contracting resulting in all manner of benefits for the national economy: lower transaction costs, capital market development, increased capacity to withstand exogenous economic shocks, and arms-length contracting/improved integration of the national economy. These benefits should result in a marked improvement in GDP growth with positive knock on effects as to broader development indicators (e.g., HDI). However, in many cases countries have

¹⁰ “Big Push” referring to the 1942 Rosenstein-Rodan model of economic development as summarized in: HlaMyint. 1969. *The Economics of the Developing Countries*. London: Hutchinson, p. 119

¹¹ Kevin Murphy, Andrei Shleifer, Robert Vishny. 1989. “Industrialization and the Big Push,” in *Journal of Political Economy*, vol. 97:5, pp. 1003-1029.

experienced significant economic growth and development absent the rule of law. The relationship between the two phenomena remains unclear. Does legal reform promote economic growth or does economic growth promote legal reform? How do these two variables interact? Does growth stemming from differing sectors of the economy have different effects on the development of the legal system? What role do informal and private order institutions play as either (i) substitutes for the law rule of law and/or (ii) way stations along the path to the establishment of the rule of law? Concomitantly, a brief glance at the recent history of the People's Republic of China raises the question as to whether or not the rule of law is even a necessary condition for long term economic growth: thirty years of uninterrupted GDP growth must be considered "long term" by any definition of the term.

Recognizing the ambiguity in the relationship between the broader economy and the legal system together with the shift in development studies away from top-down, Rostovian models, research in law and development and the policy frameworks of legal programming in multilateral and bilateral development agencies have shifted away from one-sized-fits-all institutional transplants and the diffusion of a standardized set of best practices. The national locus of legal reform is no longer understood as a sort of *tabula rasa*; conversely, economic and political conditions on the ground matter as they do in the evolution of any institution. This dissertation conceptualizes law as an institution, adopting the definition of institutions utilized by Streeck and Thelen:

"Very generally, institutions may be defined as building blocks of social order: they represent socially sanctioned, that is, collectively enforced expectations with respect to the behavior of specific categories of actors or to the performance of certain activities. Typically they involve mutually related rights and obligations for actors distinguishing between appropriate and inappropriate, right and wrong, possible and impossible actions, and thereby organizing behavior into predictable and reliable patterns."

This dissertation attempts to bring an understanding of those economic conditions into the discussion and place them at the center of the debate as regards the causality behind legal demand ultimately making a broader contribution to the political science literature on institutional change in general and the development of legal institutions in particular.

The Causal Argument I: Market Power and Legal Demand

Over the course of the last thirty years, court systems in the post-Soviet world have developed along significantly different trajectories with extreme divergences as regards outcome, specifically: usage (number of cases per annum), efficiency (speed of adjudication), and monopoly position (state courts as the sole provider of law). In order to contribute to the debate as to the causality behind legal demand, this dissertation examines why those divergences have occurred and sets out a series of hypotheses that shed new light on the economic conditions which support judicial reform. If a particular set of economic conditions are necessary in order for legal demand to develop – as hypothesized herein – then a great deal of legal reform programming has been putting the cart before the horse. By determining which are beneficial and which are

deleterious, it becomes possible to fundamentally revise how we do “legal development” and a strong case can then be made for the inseparability of legal reform and economic reform technical assistance programming. The central economic aspect doing the causal work in the legal demand story in the former Soviet Union is “market power.”

Market power is generally defined as “the ability of a firm (or group of firms) to raise and maintain price above the level that would prevail under competition; the exercise of which leads to reduced output and loss of economic welfare.”¹² As conceptualized in this dissertation, the primary aspect of market power is less the ability of a firm or group of firms to manipulate the price level of their outputs, rather it is the ability of firms to manipulate (through “take it or leave” contracting) relationships with their suppliers. This definition is particularly apt in the former Soviet space, where owing to the legacy of Soviet industrialization provincial economies are often dominated by a very small number of large firms, relationships with which can make or break small and medium sized firms.¹³ Also, it is essential to note that an inherent aspect of this conceptualization of market power are the close political ties that firms maintain to the state, either formally (through state investment) or informally (through executives holding positions in the ruling party or directly in government). On

¹² OECD. 2015. *Glossary of Statistical Terms*. <https://stats.oecd.org/glossary/detail.asp?ID=3256> (Accessed November 14, 2015)

a final note, a Herfindahl-Hirshman Index while considered as a way to measure market power was ultimately not utilized in that that index measures concentration within an industry rather than within the economy as a whole (whether regional or national). Conversely, the simpler measure of the share of GDP contributed by the largest firms serves as the measure of market power.

The concept of legal demand is set out in detail in chapter two, it is understood in this dissertation as the desire of economic actors to utilize formal systems of dispute resolution, i.e. the courts. There have been few attempts at measurement of legal demand, as a proxy I utilize the number of contract dispute cases filed in the economic courts. While this cannot be said to fully capture legal demand – as inevitably there will be firms that will want to utilize the courts but do not do so for a variety of other reasons – it does have value when utilized over a period of multiple years. Specifically, it is able to illustrate whether or not firms are responding to increases in the supply of law and can provide a series of “snapshots” as to the view of the courts held by economic actors. By utilizing data stemming from actual choices made by economic actors within the country, it is possible to overcome many of the barriers presented by the more common “perception” measures regularly employed to measure the state of the courts in less developed countries. Sub-national comparison of legal demand is facilitated by a measure that is able to weight the different sizes of the economies of each province, i.e., by dividing the total number of contract cases in a province by the

share of national GDP that province contributes. Alternative approaches, such as weighting by GDP per capita were considered, but were ultimately rejected as this measure would not adequately capture realities on the ground.

Grounded by these conceptualizations, I hypothesize that in those states where the economy is dominated by a small number of large firms which maintain close political ties to the state, i.e. where market power is high, demand for law will remain weak thereby undermining the process of legal reform and any attempts at reform based around increasing the supply of law. Owing to the outsize influence of large firms with significant market power, I contend that small and medium sized firms will seek out alternative locations for dispute resolution, e.g. independent arbitration tribunals. These alternative locations act as a drain on legal demand, undermining the reform of the legal sector. Conversely, in those locations where the economy is not highly concentrated (low market power on the part of larger firms) but rather economic activity is dispersed across a diversity of small and medium sized enterprises, legal demand will flourish. No specific threshold is set out here beyond which market power becomes operative as an impediment to legal demand; however, this dissertation demonstrates that when an economic space is dominated by a few large firms, legal demand remains anemic. Specifying a clear threshold is a goal for subsequent research. Herein rather, I simply test the following two hypotheses:

1. Countries and provinces where the economy is marked by relatively high market power by a small number of firms which received the bulk of the country's FDI, there will be low demand for law.¹⁴
2. Countries and provinces in which large firms have relatively low market power and the economy is predominantly comprised of small and medium sized enterprises receiving relatively low levels of FDI, there will be low demand for law.

Figure 1.0: Conditions Facilitating/Undermining Legal Demand

Firm Type	Market Power	Legal Demand
Large Firms	High	→ Low
SMEs	Low	→ High

“High Demand” and “Low Demand” as used here as relative rather than absolute terms, the spectrum of demand being defined by the tail ends of the total set of cases in each country, in other words the provinces that have the most and the least number of cases after weighting by the size of their overall economy. For various reasons,

¹⁴ In light of the problematic nature of measuring “success” in legal reform – a variable dominated by surveys of foreign and domestic businesspeople with wildly different results (e.g. a 2014 UNDP survey of Kazakhstan which managed the remarkable feat of concluding that 89% of Kazakh court users were “satisfied” with their experience in the civil courts) – this dissertation sidesteps the problem by utilizing “legal demand” as the dependent variable. As noted below, Pistor et al (2007) have successfully shown the causal importance of legal demand in facilitating improvements to the judiciary. However, the variables which facilitate legal demand have yet to be identified. Berkowitz et al note with regard to legal demand, “... for legal institutions to be effective, a demand for law must exist so that the law on the books will actually be used in practice and legal intermediaries responsible for developing the law are responsive to this demand.” Daniel Berkowitz, Katarina Pistor, and Jean Francois Richard. 2001. “Economic Development, Legality, and the Transplant Effect,” William Davidson Working Paper Number 410.

developing a standard for what constitutes “high” or “low” legal demand is exceedingly difficult. Japan, for example, maintains a civil court system which scores highly on every rule of law measure, yet levels of litigation are quite low. By engaging in sub-national comparative research, this dissertation is able to avoid the problems inherent in cross-national comparisons of legal systems. When cross-national comparison is made, it is only done within the post-Soviet space, across two states that share both a legal culture as well as a common historical set of legal institutions.

As discussed in the following section,, the role of FDI also holds significant explanatory power. When FDI is directed primarily towards the largest firms in the economy and supports market concentration, legal demand will remain low. In addition, hypothesizing that the demand for efficient legal institutions (demand for law) is determined by the presence or absence of a small set of large firms which dominate the overall economy, I contend that if firms are incentivized to ignore or to go around formal legal institutions, courts will not be engaged with the set of norms that actually govern market behavior. Absent this demand, reform initiatives and legal transplants focused on the supply side, i.e. improving the quality of the judiciary and the bar, enforcement of rulings, and reforms to the civil code will be unsuccessful.

Before moving forward, a final caveat as regards the dependent variable here: legal demand and its relationship to “successful legal reform.” Valery Zorkin, the current president of the Constitutional Court of Russia provides a useful summary as to

the meaning of “success” in legal reform in the context of the Russian Federation: "Complete legal reform should normally include not only judicial reform, but also reform of various aspects of the structural system and content of legislation, legal education, legal awareness by the population, and also the corporate consciousness of the whole legal community. Judicial reform usually aims to improve such things as law courts, procuracies, advocacy (the bar), inquest, executory processes, and record keeping."¹⁵ There remain significant differences in the literature as to how best to conceptualize success in legal reform and whether it is necessary to take the sort of expansive, systemic approach adopted by Zorkin. In light of these differences, this dissertation rejects the systemic approach and limits its focus to the civil court system, specifically to economic courts with purview over the resolution of contractual disputes and the demand for those services.

The Causal Argument II: Legal Reform and Foreign Direct Investment

Understanding the role of FDI in the creation of legal demand is essential; ergo, I scrutinize the structure of the economies of these states and argue as that the presence of foreign direct investment (FDI) is not an unmitigated positive for the development of civil court systems. One of the strongest bodies of research guiding law and development is that which has focused on the question of global economic integration as a means to facilitate improvements in the quality of the bench and the bar, bringing

¹⁵ Valery Zorkin. 2007. “Twelve Theses on Legal Reform,” in Francis Neate and Holly Nielsen (eds) *The World Rule of Law Movement and Russian Legal Reform*. Moscow: Moscow Chamber of Advocates.

in global in addition to national context.¹⁶ Nevertheless, the literature on FDI and legal reform has reached a diverse set of conclusions. FDI has been hypothesized as facilitating improvement through a process of diffusion. Moreover, FDI purportedly incentivizes firms to utilize formal legal institutions and to engage in “lawful business” through the possibility of an initial public offering (IPO) on a foreign stock exchange and the prospect of increased access to capital. Cross-country and in-country studies have contended that FDI is therefore an unambiguous good supporting the development of legal systems which allow firms to optimally vertically integrate, capture an increasing share of global trade through efficiency gains, and contribute to economic growth ultimately further increasing FDI in a virtuous circle. More often than not, as Bevan et al argue, the conventional wisdom has been that the better the quality of local legal institutions, the greater the amount of FDI which will be attracted. FDI is understood not so much as a causal variable impacting legal reform but as a “carrot” to reward those states which have developed efficient, transaction cost lowering legal institutions.¹⁷

¹⁶ Amanda Perry. 2000. “Effective Legal Systems and Foreign Direct Investment: In Search of the Evidence,” in *The International and Comparative Law Quarterly*, Vol. 49: 4, pp. 779-799. John Dunning. 2004. “Institutional Reform, FDI and European Transition Economies,” in R. Grosse (ed.) *International Business and Governments in the 21st Century*. Cambridge: Cambridge University Press. John Dunning and Kim, Chang-Su and Lin. 2001. “Incorporating Trade into the Investment Development Path: a Case Study of Korea and Taiwan,” in *Oxford Development Studies*, vol. 29:2. pp. 45-54. Daniel Holland et al. 2000. “The Determinants and Impact of FDI in Central and Eastern Europe: A Comparison of Survey and Econometric Evidence,” in *Transnational Corporations*, vol. 9:3, pp. 162-212.

¹⁷ Alan Bevan, Saul Estrin, and Klaus Meyer. 2003. “Foreign Investment Location and Institutional Development in Transition Economies,” in *International Business Review*, vol. 14:3, pp. 43-64.

Conversely, I argue that global economic integration and FDI often have negative implications for legal reform and the structure of the local economy can result in the effects of FDI being far removed from those hypothesized. The question of “power” – the origin, usage, and implications of which are the primary question of political science - specifically market power needs to be incorporated into any analysis of the role of FDI. This dissertation illustrates that when FDI is directed primarily to large firms it can serve to distort the economy of the recipient state – e.g. through, the undermining of the SME sector and buttressing market dominance by large firms - with negative knock on effects both as regards economic diversification as well as the development of the civil courts. Only when FDI supports the development of the SME sector will its mooted benefits as regards legal reform be achieved. In the same way that development studies research in recent years has focused on policies which support “pro-poor growth,” i.e. growth with disproportionately impacts the bottom quintile of the population, I argue that development policy as regards FDI should be “pro-poor SMEs,” i.e., supporting resource starved SMEs.

At the same time, FDI does not necessarily flow only to those economies with legal institutions viewed by investors as “high quality.” Rather, following Kinoshita and Campos, investment in certain industries can result in sufficiently high payoffs to foreign firms such that the weaknesses in the local set of legal institutions is

disregarded.¹⁸ It is essential to understand the impacts of FDI in economies with weak (inefficient, slow, un-utilized, non-monopoly position) legal institutions.

The Post-Soviet States: A Natural Field Experiment

The announcement of the policy of *Perestroika* in the Soviet Union in 1985 by Mikhail Gorbachev began an era of remarkable institutional and social change which has continued, almost unabated, to the present day. The outcomes have been diverse. With the exception of the Baltic economies, Russia and the other successor states to the USSR have experienced relative economic decline, economic stagnation, and a cycle of boom and bust made manifest most recently by the 2014 *ruble* crisis and the 2015 devaluation of the Kazakh *tenge*.¹⁹

Research in political economy and comparative economics has convincingly explained, emphasizing a diverse set of causes (relative GDP, levels of urbanization, access to foreign direct investment, gradualist vs. “big bang” models, etc.), the divergent results of reform in the transition economies.²⁰ Conversely, other aspects of the transition away from state socialism and towards a market economy have received less attention in comparative political economy and economics. While there are factors

¹⁸Yuko Kinoshita and Nauro Campos. 2003. “Why Does FDI Go Where It Goes? New Evidence from the Transition Economies,” William Davidson Institute, Working Paper 573. Ann Arbor, MI: University of Michigan.

¹⁹ Anders Aslund. 2001. *Building Capitalism: The Transformation of the Former Soviet Bloc*. Cambridge: Cambridge University Press. Mikhail Alexseev and Shlomo Weber. 2013. *The Oxford Handbook of the Russian Economy*. Oxford: Oxford University Press.

²⁰ Pei Minxin. 1998. *From Reform to Revolution: The Demise of Communism in China and the Former Soviet Union*. Cambridge: Harvard University Press. Peter Nolan. 1996. *China's Rise, Russia's Fall: Politics, Economics, and Planning in the Transition from Stalinism*. London: Palgrave. Barry Naughton. 1995. *Growing Out of the Plan: Chinese Economic Reform 1978-1993*. Cambridge: Cambridge University Press.

that present challenges to structured, focused comparison, e.g., size, economic structure, resource dependence – the reform of the post-socialist economies still represents one of the most significant natural field experiments available to scholars in the social sciences owing to the sheer number of variables which can be held constant and the shared institutions maintained by the constituent republics when the USSR disintegrated. Moreover, deeper comparison provides the opportunity to problematize existing models, depict the value of comparative research within rather across states, and cast new light on myriad questions across several different disciplines.

Particularly amenable to comparative analysis is the question of legal reform, specifically judicial reform and the creation of a working system for the adjudication of contractual disputes. At the time of independence, the 15 constituent states of the former Soviet Union (together with Mongolia and several of the Eastern European states) maintained a common system for the resolution of contractual disputes, the State Arbitration System (*GosArbitrazh*). These institutions trace their origin to the years immediately following the Russian Revolution. Following the adoption of the New Economic Policy by the Soviet government in 1921, a set of arbitration (*Арбитраж*) commissions were created. Devised by the Soviet legal and economic theoretician Nikolai Bukharin, drawing on elements of Russian imperial era commercial law, and utilizing the skills of Tsarist era attorneys, these entities were designed to handle

disputes between the remaining, privately held firms.²¹ Arbitration commissions would subsequently be established across the USSR in 1931 in the form of a system of *GosArbitrazh* which served as the locus of contract dispute resolution between ministries and state enterprises. State arbitration subsequently was expanded throughout the USSR. By the 1950s the system handled all contractual disputes between economic actors (ministries, firms, individual factories, etc) within the Soviet bloc as well as those between COMECON economic entities and those western firms which did business behind the Iron Curtain. Following the dissolution of the USSR in 1991, state arbitration was formally converted into the commercial court system of the newly christened Russian Federation (*Арбитражный Суд Российской Федерации*). This conversion took place in most of the successor states to the USSR – again, excluding the Baltic economies which returned to their pre-1945 systems – and these courts today serve as the post-Soviet equivalent of western civil court systems with sole purview over contractual disputes.²² However, there are significant differences as to the utilization of these courts across the post-Soviet world. In the northwest judicial district of the Russian Federation (St. Petersburg), the arbitration courts have seen consistent growth in the number of cases, improvements in time to adjudication and the withering away of Soviet style private arbitration. Conversely in Kazakhstan, the economic courts remain under-

²¹ Peter Boettke. 1990. *The Political Economy of Soviet Socialism: the Formative Years 1921-1928*. New York: Springer. Paul R. Gregory. 2003. *The Political Economy of Stalinism*. Cambridge: Cambridge University Press.

²² Kathryn Hendley, Peter Murrell, and Randi Ryterman. 2000. "Law Works in Russia: The Role of Law in Interenterprise Transactions," in Murrell (ed.) *Assessing the Value of Law in Transition Economies*.

utilized and firms regularly use alternative means to resolve contractual disputes. In the following chapters, I illustrate how the differences in market power and the size of the SME sector are able to explain the differing levels of legal demand across both these two countries as a whole as well as across their (combined) 102 constituent provinces.

Why Contract? The Centrality of Contract Law in Legal Reform

There is a general consensus in the literature that contract law is the true center of the discipline of comparative law and thus must take a central place in evaluating the outcomes of legal reform. As Allen Farnsworth points out: “Of all areas of law, perhaps none has been subjected to comparative study as consistently, frequently, and intensely as contract law.”²³ This is born out in the publications on the subject: the topic takes up two of the seventeen volumes of the *International Encyclopedia of Comparative Law* and it comprises more than half of the subject matter in Konrad Zweigert and Hein Kötz’s classic *An Introduction to Comparative Law*.²⁴ Zweigert and Kötz’s set out two main contentions for the centrality of contract law. First, owing to its Roman origins, in the civil law tradition contract has always been viewed as the pre-eminent area of law. Second, contract law is one of the most practically salient areas, with relevance for economic development as well as in the realities of international negotiation and litigation. Additionally, as Riesenfeld points out, contract law has the longest pedigree

²³Allan Farnsworth. 2006. “Comparative Contract Law,” in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law*. New York: Oxford University Press.

²⁴Konrad Zweigert and Hein Kötz. 1996. *Einführung in die Rechtsvergleichung*, in English translation by Tony Weir, *An Introduction to Comparative Law*. New York: Oxford University Press.

in legal reform projects, beginning with the importing of portions of German contract law in East Asia and the United States in the 19th century.²⁵ More generally, the venerable legal scholar Henry Sumner Maine underlined the predominance of private agreements in “the movement of progressive societies from status to contract.”²⁶ While John Reitz highlights contract law as the bridge which links the study of comparative law to contemporary political economy,²⁷ Reitz’s perspective finds support in a brief glance at the political economy literature, specifically work on the varieties of capitalism literature where both Steven Casper and Gunter Teubner have both researched contract issues.²⁸ Herein success in legal reform is understood as the existence of an efficient set of formal, state institutions tasked with the adjudication of contractual disputes which do so in a timely manner (relative to global benchmarks) and which have displaced pre-existing, traditional forms of dispute resolution.

This focus on contract law also resolves many of the problems which bedevil other bodies of law. While, for example, there has been a remarkable growth in the study of competition law in recent years – there are myriad unresolved questions as to

²⁵ Stefan Riesenfeld. 1993. “The Impact of German legal Ideas and Institutions on Legal Thought and Institutions in the United States,” in Mathias Reimann (ed.), *The Reception of Continental Ideas in the Common Law World 1820-1920*.

²⁶ Henry Sumner Maine. 1861. *Ancient Law: Its Connection with the Early History of Society and Its Relation to Modern Ideas*. London: John Murray.

²⁷ John C. Reitz. 2007. “Political Economy and Contract Law,” University of Iowa Legal Studies Research Paper: 07-06. University of Iowa College of Law.

²⁸ Steven Casper. 2001. “The Legal Framework for Corporate Governance: The Influence of Contract Law on Company Strategies in Germany and the United States,” in Hall and Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. New York: Oxford University Press. Gunter Teubner. 2001. “Legal Irritants: How Unifying Law Ends up in New Divergences,” in Hall and Soskice (eds.), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage*. New York: Oxford University Press.

how to evaluate its success and even how to determine what its appropriate outcomes should be. The question of “best practice” in contract law is much more settled, most notably in the work of International Institute for the Unification of Private Law. This organization’s 2004 working group produced the UNIDROIT Principles of International Commercial Contracts, which were subsequently formally endorsed by the United Nations Commission on International Trade LAW (UNCITRAL) in 2007 and established a global standard as a model for national and international legislators. In addition, unlike insolvency, competition, securities, and secured transactions regulation – contract law avoids the necessity of evaluating the role of an additional executive regulatory agency and usefully limits the analysis to legislators, parties to contracts, and the judiciary. Finally, contract law is *prior* to many other types of law. Ayotte and Yun point out in their study of insolvency law reform that optimal bankruptcy laws depend to a great extent on the quality of existing contract law.²⁹ Following in this tradition, this dissertation explores the conditions required to establish courts for the adjudication of contract utilizing a comparative case study approach, specifically the transition economies of Russia and Kazakhstan. I contend that these cases are able to provide significant leverage in understanding the dynamics of legal reform.

²⁹Kenneth Ayotte and HayongYun. 2007. “Matching Bankruptcy Laws to Legal Environment,” in *Journal of Law, Economics, and Organization*, vol. 25:1, p. 25.

Extrapolations: Aid Policy and Technical Assistance

The implications of these arguments are vast for bilateral and multilateral institutions work on legal reform in less developed countries. For a country such as Kazakhstan which has seen SMEs flee the formal court system in favor of private arbitration institutions, it raises questions as to whether resources should continue to be devoted to the moribund economic courts or re-directed to the network of well regarded, non-state arbitration tribunals.

With regard to aid policy, Easterly and Banerjee have highlighted the problem of lack of coordination among development agencies despite the increased attention paid to this issue in recent year.³⁰ If legal demand is inherently linked to the structure of the economy, it will be more imperative to better coordinate the activities of the various development agencies working on economic reform, promotion of the SME sector, and legal reform. The relationship of aid and FDI is also of interest. In this case, OECD economies continue to support FDI as a core component of development through subsidized insurance programs such as the Overseas Private Investment Corporation (OPIC) in the United States and the World Bank's Multilateral Investment Guarantee Agreement (MIGA). At the same time, capacity building programs for legal reform in less developed countries, as noted above, are a core component of poverty reduction

³⁰ William Easterly. 2006. *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good*. New York: Penguin Press. : Abhijit Banerjee and Esther Duflo. 2013. *Poor Economics: A Radical Rethinking of the Way to Fight Poverty*. New York: Public Affairs.

plans and long term development strategies implemented by development agencies. Rather than working in congruence to support the improvement of legal systems, these programs appear to be working at cross purposes – with the deleterious effects of FDI making the effects of capacity building programs, at best, moot.

Structure and an Outline of Chapters

The dissertation is structured as follows. Chapter two provides a broad literature review and places this work in the relevant arenas of political science, comparative law, and economics. Chapter three sets out the case of Kazakhstan, highlighting in particular the significant expansion of private arbitration in recent years and the remarkable stagnation in legal demand despite the enormous growth that country has experienced over the past two decades.

The empirical chapters that follow are organized around the respective cases. Chapter three sets out the development of the legal system in Kazakhstan since the advent of reform, inclusive of the myriad reform programs supported by various development agencies as well as the ABA CEELI project, i.e. those initiatives which have focused on the “supply of law.” Utilizing data from courts across the various oblasts, I demonstrate that supply alone has been unable to achieve the goal of a high quality judicial system. Rather, I show how the massive inflow of FDI in the early 2000s contributed to economic dominance by a small set of resource based conglomerates. At the same time, foreign investors played a significant and successful role in pressuring

the government to alter the existing laws on private arbitration in order to ensure that awards made by arbitration bodies (e.g. the International Chamber of Commerce) were enforceable in Kazakhstan. An inadvertent impact of this was the massive expansion of private arbitration within the country which could subsequently rely on the bailiff system to enforce the awards of these entities. While the country's largest firms continue to use the courts in disputes with some outside contractors, owing to their role as holding companies, they have also established in-house arbitration procedures to manage disputes between component firms further weakening the demand for law. Finally, I explore differences within the country – in those few regions where SMEs do maintain significant market power, I demonstrate that there is less reliance on private arbitration and greater utilization of the economic court systems.

The fourth chapter explores the Russian case, where growth in legal demand correlates with the burgeoning of the SME sector in the early 2000s. I show how in those provinces where a few large firms are dominant, legal demand has significantly lagged and informal systems of arbitration have been maintained. Unlike Kazakhstan, owing to the re-nationalization policy of the Russian government, FDI shifted out of the resource sector and the larger, politically connected firms and shifted towards other industries and has served to support the development of the SME sector, particularly in the Russian Far East and Northwest provinces, relative to the moribund levels found in the

single industry towns and resource dominated regions in the Urals region and Western Siberia.

The final chapter concludes this dissertation by exploring the policy implications of this research with regard to aid policy as well as bilateral and multilateral underwriting of FDI. I end by raising the point that in country's such as Kazakhstan, rather than supporting state courts – assistance should be directed towards an expansion of the private arbitration sector which has shown its utility in increasing predictability and lowering transaction costs for SMEs. Achieving the rule of law or simply an efficient economic court system is a laudable goal, but in light of the economic structure of certain states, support for the “second best” option of private arbitration should increasingly be considered.

Chapter Two

The Political Economy of Legal Reform: State of the Literature

Types of Legal Reform

The literature on legal reform and legal change is diverse – in every sense of the word. It cuts across the disciplines of political science, comparative law, economics and policy analysis - with each field focused on highly distinct sets of questions. However, the concept of legal reform has generally been sub-divided into three separate categories: imposition of law through violence; change produced by the desire to follow prestigious models; and reform for the purpose of improving economic performance.³¹ While the concept of legal demand is of relevance for the effectiveness of all types of legal reform, this dissertation focuses on the third type.

Concerning the first of these, legal reform is understood as the result of military conquest or expansion, e.g., the extension of German law to Austria following the Anschluss of 1938 and the Sovietization of Eastern and Central European law are cases in point.³² The concept of “imposed” legal reforms derivative from an institutional origin of military conquest or expansion are outside the scope of this project. Reforms of that type are likely to differ significantly from those finding their origins in issues of prestige and economic performance. Furthermore, more often than not, legal reform occurs without large-scale violence. The story of legal reform in “imposed” cases may be

³¹Michele Graziadei. 2006. "Comparative Law as the Study of Transplants and Receptions," in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law*. New York: Oxford University Press.

³²W.E. Butler. 1983. *Soviet Law*. London: Butterworths. Jurgen Gehl. 1963. *Austria, Germany, and the Anschluss 1931-38*. New York: Oxford Press.

considered in the terminology of Streeck and Thelen, one of simple “displacement,” with change facilitated by the “invasion (literally) and assimilation of foreign practices.”³³

Conversely, the issues of prestige and economic reform are at the heart of issues facing transition economies today and during the initial periods of reform in the 1980s and 1990s, and are the areas to which attention is paid in this project.³⁴ These two approaches and most other segments of literature on legal change have been developed through the framework of (or at least in dialogue with) so-called “legal transplants,” a term fraught with perilous definitional hazards. As Graziadei argues, the term itself is based on a metaphor that was chosen *faute de mieux*, and it is ill-adapted to capturing the gradual diffusion of the law or the continuous nature of the process that sometimes leads to legal change through the appropriation of foreign laws.³⁵ The term can generally be understood to mean: a legal rule which, after being developed in a ‘source’ body of law, is then introduced into another ‘host’ body of law. Nevertheless, the inherent untidiness of the concept raises a number of questions: How extensive is the

³³Wolfgang Streeck and Kathleen Thelen. 2005. *Beyond Continuity: Institutional Change in Advanced Political Economies*. New York: Oxford University Press. Kathleen Thelen. 2004. *How Institutions Evolve: The Political Economy of Skills in Germany, Britain, the United States, and Japan*. New York: Cambridge University Press.

³⁴Randall Peerenboom. 2002. *China’s Long March to Rule of Law*. New York: Cambridge University Press. Kathryn Hendley. 1996. *Trying to Make Law Matter: Legal Reform and Labor Law in the Soviet Union*. Ann Arbor: University of Michigan Press. Ann and Robert Seidman. 1994. *State and Law in the Development Process: Problem-Solving and Institutional Change in the Third World*. London: St. Martin’s Press. Curtis Milhaupt. 2003. *Global Markets, Domestic Institutions: Corporate law and Governance in a New Era of Cross Border Deals*. New York: Columbia University Press. Kamal Ahmed et al. 2005. *Law and Policy Reform at the Asian Development Bank*. Manila: ADB.

³⁵Graziadei 2006, p. 443.

required development in the source body of law? How does one distinguish a “pure” transplant from an “indigenous” law? Despite the problematic nature of the term, this body of work is at the core of the literature on legal reform and any discussion of the topic must take into account its contributions. Reviewing this research is particularly important as legal reform in transition economies and LDCs has by and large been developed around the import of legal rules from foreign states.

The Feasibility of Legal Reform: Watson, Legrand, and Legal Demand

The contemporary study of legal reform thus finds its origins in the 1970 Congress of the International Academy of Comparative Law which dedicated a section of that meeting to “the global reception of foreign law.”³⁶ Four years later, Alan Watson singled out the issue as a major subject for comparative legal studies and developed one of the two main approaches to the study of legal transplants.³⁷ Watson’s work remains the standard starting point for analyses of legal reform, and thus serves as the jumping off point for this dissertation’s review of the state of the literature. His approach represents one side in the long running “context vs. autonomy” debate, with Watson carrying the banner for autonomy and Pierre Legrand waving the flag of context.³⁸ Watson provides rich evidence that transferring legal institutions between societies has been an enormous historical success and has served as the fundamental

³⁶As Graziadei 2006 points out, the important precedent was the conference on “Reception of Foreign Law in Turkey,” held by the International Association of Legal Sciences in Istanbul in 1955.

³⁷Alan Watson. 1974. *Legal Transplants: An Approach to Comparative Law*. Athens: University of Georgia Press.

³⁸Pierre Legrand. 1997. “The Impossibility of Legal Transplants,” in *Maastricht Journal of European and Comparative Law*, vol. 111.

basis for legal change, despite the diversity of social structures that these institutions encounter. He explains the success of these transfers as dependent upon the highly developed autonomy of the modern legal profession, in other words a supply of law argument.³⁹ It is contended that when states possess well trained attorneys and self-governing bar associations, the incorporation and utilization of new elements of law, e.g. global best practice models, will succeed. Hence, the law and development movement for many years placed at the core of its programming assistance for legal education and the strengthening of the bar. Arguing against functionalist comparativists, Watson contends that neither cultural approaches nor socio-economic structures should be given any causal weight in explaining successful legal reforms. In what was at the time a complete re-conceptualization of comparative law, he argued that rather than simply studying the content of foreign law, the field must also analyze the interrelations between different legal systems.⁴⁰ While in earlier eras the transfer of laws from one state to another was exceedingly hazardous, due to long term historical processes of differentiation and globalization, the current situation is quite different. The primary unit of analysis should no longer be the nation (which, following Montesquieu, expresses its unique spirit in a law of its own as a cultural experience that cannot be shared by other nations with differing cultural traditions). Rather, national

³⁹Alan Watson. 1991. *Legal Origins and Legal Change*. London: Hambledon Press. Alan Watson. 1983. "Legal Change: Sources of Law and Legal Culture," in *University of Pennsylvania Law Review*, vol. 131.

⁴⁰William Ewald. 1995. "Comparative Jurisprudence (II): The Logic of Legal Transplants," in *American Journal of Comparative Law*, vol. 43, pp. 489-510.

laws in the modern era have been separated from their original comprehensive embeddedness in the culture of the nation.⁴¹ For Watson, globalizing processes have created a single network of legal communications which downgrades the laws of nation-states to mere regional parts of this network. Hence, the transfer of legal institutions is no longer a matter of an interrelation of national societies where the transferred institution carries the entire burden of the original national legal culture. Conversely, he posits that the situation of law across all states is one of continuous, direct contact between legal orders within one global legal regime – thereby explaining the frequent and relatively easy transfer of legal institutions (mediated by members of the bar) from one legal order to the other. However, as the cases of Russia and Kazakhstan will demonstrate, this global diffusion approach has not been borne out – significant investments in the bar, the expansion of international best practices, and the training of lawyers abroad does not necessarily result in actual usage of the courts.

For Watson, these transplants are the main source of legal change – the bar which he values so dearly prefers to take over rules and principles from foreign legal orders rather than reacting directly to external stimuli from society. He traces this to certain peculiarities of the legal profession, specifically its need to argue from precedent and authority with a marked preference for deriving solutions from legal tradition rather than creation of new law *ex nihilo*. This approach maintains certain parallels with

⁴¹ *Ibid*, p. 498.

the punctuated equilibrium models of institutional change in political economy. However, in a sense Watson's approach begs the question of how legal change occurs. Reading Watson's arguments from a Neo-Institutionalist approach, his theory contends that legal change in the form of legal borrowing and successful legal transplant is due to a change in preferences among the members of the bar. However, as he isolates the bar fully from the broader socio-economic conditions, we are still left asking why change takes place at all. Moreover, it is unclear how collective action by members of the bar to accomplish an institutional transplant takes place. How do members of the bar push firms to alter existing strategies of dispute resolution? Why would firms which see positive results from current, informal systems shift to a risky, untried formal legal system?

Watson's claim that legal reform takes place in splendid isolation from social changes is problematic in other ways, particularly in those states which have transplanted laws and do not have the type of bar which Watson contends is primary (e.g., the transition economies at the center of this study and most less developed states). Moreover, Watson's conceptualization of a "modern, autonomous bar" raises serious questions – he does not define the term in a sufficiently detailed manner to allow for social scientific testing of his hypothesis and measures as to the quality of the bar and its level of self-governance remain imprecise at best and *ad hoc* at worst. It

seems that his explanation does not travel beyond the rarefied cases of western, developed economies.

At the other end of the explanatory spectrum stands the second main explanatory approach, that of Pierre Legrand.⁴² Working from an anthropologically informed culturalist perspective, Legrand contends that legal systems are essentially idiosyncratic. While certain convergences take place on the level of legal rules as institutions, the deep structures of “law, legal cultures, legal mentalities, legal epistemologies, and the unconscious of law as expressed in legal mythologies remain historically unique and cannot be bridged.”⁴³ For Legrand, legal transplants are exposed to the insurmountable differences of cultural organisms, they cannot survive the surgical operation of transplant into another legal system:

“Rather the rule, as it finds itself technically integrated into another legal order, is invested with culture-specific meaning at variance with the earlier one. Accordingly, a crucial element of the ruleness of the rule, its meaning, does not survive the journey from one legal culture to another.”⁴⁴

Legrand’s approach is a contemporary reformulation of Montesquieu’s culturalist skepticism (discussed above), but with one key modification. For Legrand, the *esprit des lois* is a reflection of a specific legal culture rather than a broad reflection of an overall natural culture.

⁴²Legrand 1997.

⁴³ *Ibid*, p. 117.

⁴⁴Pierre Legrand. 1997. “What Legal Transplants?” in David Nelken (ed). *Adapting Legal Cultures*. Portland, OR: Oxford Press.

Legrand's work is also not without problems – most notably, it is unable to take account of successful legal reforms and those cases where legal demand does actually increase. Philip Nichols argues that when Legrand's conceptualization of legal transplant is formulated in the language of testable hypotheses, his argument comes down to the contention that transplanted laws that do not comport with the legal culture of the host country will not be accepted and instead will either be ignored or rejected – the host rejects the organ, in medical terms.⁴⁵ Nichols tests that prediction through a case study of Kazakhstan's foreign investment code and finds that although the law did not emerge from the culture of Kazakhstan and does not comport with Kazakh legal culture, the law was accepted – successfully falsifying Legrand's theory. While Nichols is able to illustrate that the foreign investment code is being utilized, he does not provide data as to the number of cases and what allegedly is driving legal demand in this case.

The Politics of Legal Reform: A Step Forward

Within the discipline of comparative law, other approaches between the extremes of Watson's autonomy approach and Legrand's extreme contextualism have presented more optimistic avenues for understanding legal reform and opened up space for contributions from political science. This strand of the literature builds on the work of Otto Kahn-Freund who argued that politics is an important factor in

⁴⁵ Philip Nichols. 1997. "The Viability of Transplanted Law: Kazakhstani Reception of a Transplanted Foreign Investment Code," in the *University of Pennsylvania Journal of International Economic Law*, 18:4.

determining the feasibility of legal reform, providing a much needed bridge for political scientists to enter the debate.⁴⁶ Kahn-Freund's insight has been built on most strongly by Lawrence Friedman, who makes the claim in his classic *History of American Law* that "law is reshaped by change, that nothing is historical accident, nothing is autonomous - everything is molded by economics and society."⁴⁷ The basic thesis that Friedman advances is simply that law changes over time in response to social developments – but, importantly, law will not always faithfully reflect society.⁴⁸ Rather, law is understood as an instrument and consequence of group conflict; this is born out in his historical research which attempts to demonstrate that "law on the books" and even more so, "law in action" at any given time plays a part in constituting, filtering, and changing the balance of forces in society. While a promising approach, Friedman does not extend his political analysis to the question of legal reform. Rather, he suggests that legal reform is usually successful and if it is unsuccessful, this outcome merely illustrates that the reform is not needed by the society in question. In other words, he reduces the entire debate to one of the presence or absence of demand for law – however, he does not explain under what conditions there will be demand for law. Finally, while Friedman recognizes the role of political conflict in legal change, he at no point develops a testable theory which purports to explain the process of legal reform.

⁴⁶Otto Kahn-Freund. 1974. "On Uses and Misuses of Comparative Law," in *Modern Law Review*, vol. 37, pp.1-27.

⁴⁷Lawrence Friedman. 1985. *History of American Law*. New York: Simon and Schuster.

⁴⁸Friedman's approach thus rejects the "legal mirror" approach that has been at the core of the contemporary law and society movement by recognizing that politics and societal interests can influence the law in a way that results in a set of statutes that are not a simple reflection of some vague notion of "society."

Building on the work of Kahn-Freud and Friedman's introduction of the question as to demand for law, Gianmaria Ajani developed the first fully developed theory seeking to explain legal reform.⁴⁹ Ajani argues that prestige and political opportunity together encouraged the borrowing of law developed within the EU to the former socialist states of Eastern Europe. Particular laws are adopted as a means to a national political end, such as admission to international banking bodies or membership in the General Agreement on Tariffs and Trade. While it offers an explanation for why particular laws are chosen for transplantation, this approach remains focused solely on the question of why states provide law and entirely ignores the question of legal demand.

This approach is also somewhat problematic as it assumes a significant amount of autonomy on the part of new, weak states; the experience of which has more often been one of state capture by business elites (Yeltsin's Russia, Kuchma's Ukraine, etc). Moreover, Ajani's theory has been subject to fierce criticism by comparative law scholars who have contended that prestige is a "largely empty idea."⁵⁰ Ajani's broader problem is that while she asserts prestige as a motivating factor, she does not undertake research with sufficient micro-foundations in order to illustrate her theory with

⁴⁹Ajani, Gianmaria. 1995. "By Chance and Prestige: Legal Transplants in Russia and Eastern Europe," in *American Journal of Comparative Law*, 93:1.

⁵⁰Ugo Mattei. 1994. "Efficiency in Legal Transplants: An Essay in Comparative Law and Economics," in *International Review of Law and Economics*, vol. 14, p.3.

sufficient validity. Rather, she simply imputes a preference for prestige onto all actors, resulting in a rather shallow analysis of the question at hand.

Bringing in Economics: Turning a Corner in the Study of Legal Reform

The literature on legal reform turned an important corner in recent years, as scholars turned away from the less methodologically rigorous approach found in comparative law and began to incorporate the insights of the law and economics movement and social science research methodology into their work. Although primarily focused on common law states, this research program has developed some important insights. Most notably, there exists the contention that the rise of different legal institutions and the success of legal reforms in different societies may be related to their capacity to lower transaction costs. As Coffee and Gillespie (among others) have pointed out, the modern corporate form, trusts, and negotiable instruments replaced earlier legal forms that generated higher transaction costs.⁵¹ The conclusion of these authors is that their diffusion is a major source of legal change and must be linked to comparative advantage over alternative institutions with higher transaction costs. However, this concept is somewhat problematic in that it ignores the fact that vested interests play a major role in any form of change and implies the infallibility of institutional designers. Moreover, it assumes that a well-functioning legal system is in

⁵¹John C. Coffee. 2003. "The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control.," in Hopt and Wymeersch (eds) *Capital Markets and Company Law*. John Gillespie. 2002. "Transplanted Company law: An Ideological and Cultural Analysis of Market-Entry in Vietnam," in *International and Comparative Law Quarterly*, vol. 51.

the economic interest of all firms, while this dissertation highlights that in economies where there exists a high level of concentrated market power among a few firms, maintenance of the status quo will have higher payoffs for those few, large firms.

Law and economics scholars have also demonstrated that there is, whether by conscious choice or by social necessity, a strong tendency for the common law to adopt efficient legal rules.⁵² Moreover, this approach contends (rather simplistically) that common law grows and matures in response to social change and that older laws are either distinguished away or swept away by judges who recognize their obsolescence. Efficiency has thus been proposed as a criterion to evaluate the success or failure of legal reforms and as an approach to understand legal changing. Mattei has argued that every legal system produces different legal doctrines or techniques for the solution of a given problem.⁵³ Each of these different inputs enters into what he terms “a market of legal culture.” Within this market the suppliers meet the needs of the customers. Thus, the process of competition is able to determine the survival of the most efficient legal doctrine. The placement of efficiency at the core of the evaluation of law has led

⁵²Florian Faust. 2006. “Comparative Law and Economic Analysis of Law,” in Reimann and Zimmermann (eds) *The Oxford Handbook of Comparative Law*. New York: Oxford University Press. Robert Cooter and Thomas Ulen. 1997. *Law and Economics*. New York: Addison-Wesley. Nicholas Mercurio and Steven G. Medema. 2006. *Economics and the Law: From Posner to Post-Modernism and Beyond*. Princeton: Princeton University Press.

⁵³Mattei, 1994.

scholars such as Posner to flesh out an optimal legal environment for economic development based around the efficiency concept.⁵⁴

However, this approach also suffers from significant drawbacks. While Mattei is able to explain the adoption of efficient law, he is unable to explain what could be termed failures of the legal market – where inefficient laws predominate and barriers are created for economic development. Potential explanations are offered in the form of “tradition, ideology, and ignorance.” However, these are more ad hoc responses to particular cases rather than integral aspects of a complete theory of legal reform. Moreover, it assumes that there exists a market for law with demand for law as a sort of natural phenomenon whereby “buyers of law” are simply waiting for a good quality supplier to come along to fill their legal wants. As the last fifty years of legal reform activities have illustrated, this supply centric approach has not succeeded.

The topic of legal reform became more salient in the last decade as legal reform became an increasingly common part of the technical assistance tool box of bilateral and multilateral development institutions. Thomas Carothers has called for avoidance of the same mistakes that bedeviled legal reform programs in previous years and highlighted the importance of a research program which can provide practical input to policymakers – but he and his collaborators have yet to put forward a theoretical

⁵⁴Richard Posner. 1998. “Creating a Legal Framework for Economic Development,” in *World Bank Research Observer*, vol. 13:1, pp. 1-11.

approach explaining legal reform.⁵⁵ This is part of a general trend in the literature which provides ample “warning” while conducting very little empirical research (with a few notable exceptions). Trubek and Santos have gone so far as to call for the abandonment of all attempts at legal transplants and moving on to the development of a new model of legal reform programs incorporating social elements.⁵⁶ Inge Markovits has hypothesized the potential for a typology of legal reforms/transplanted laws; however, empirical studies have yet to be conducted to develop this hypothesis.⁵⁷ LaPorta, Lopez-de-Silanes, Shleifer, and Vishny have developed a large body of work on the relationship between law and the growth of financial markets, claiming that legal family is the key issue at hand – but have remained mostly silent as to the dynamics of reform despite their otherwise helpful research on the broader dynamics of institutions.⁵⁸ Their primary causal mechanism is also problematic: linking law to economic development, via the expansion of capital markets, ignores the financial history of East Asian development. Moreover, their legal families based explanation has received significant criticism as regards coding errors by Kenneth Dam

⁵⁵Thomas Carothers. 2006. *Promoting the Rule of Law Abroad: In Search of Knowledge*. Washington D.C.: Carnegie Endowment.

⁵⁶Trubek, David. 2006. “The Rule of Law in Development Assistance,” in Trubek and Santos 2006, pp.78-79.

⁵⁷ Inge Markovits. 2004. “Exporting Law Reform – But Will It Travel?” in *Cornell International Law Journal*, vol. 95, pp.95-114.

⁵⁸ Rafael LaPorta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. 1998. “Law and Finance,” in *The Journal of Political Economy*, vol: 106:6, pp. 1113-1155. LaPorta et al “Legal Determinants of External Finance,” in *Empirical Corporate Finance*, The International Library of Critical Writings in Financial Economics, Richard Roll (series editor) and Michael J. Brennan (editor), 2000.

and others.⁵⁹ Hay, Shleifer, and Vishny set out initial views towards developing a model of reform based on their work in post-Soviet Russia – however, this work does not move beyond a set of recommendations for initial stage reforms and does not take into account questions beyond the very short term.⁶⁰ Jonathan Miller has set out an initial “typology” of legal transplants inclusive of cost-saving, externally-dictated, entrepreneurial, and legitimacy-generating transplants.⁶¹ Nevertheless, this approach is geared more towards understanding the motivations for legal reform rather than explaining success or failure which remain vague and ill defined. Miller argues that “a fuller picture will require work that analyzes the legal history of different transplants and the creation of typologies not just of legal transplants, but of how law achieves social relevance.”⁶²

Despite four decades of research on the subject, the literature is in firm agreement that we still lack a robust theory with practical applications for what makes legal reform succeed or fail and until recently the question of legal demand has either been assumed or only received glancing attention. In a survey of the issues in contemporary legal reform, Messick identified many of the unresolved puzzles, highlighting the following questions: Is a fair judicial system a cause of good economic

⁵⁹Kenneth W. Dam. 2006. *The Law-Growth Nexus: The Rule of Law and Economic Development*. Washington D.C.: Brookings Institution Press.

⁶⁰ Jonathan Hay, Andrei Shleifer, and Robert Vishny. 1996. “Towards a Model of Legal Reform,” in *European Economic Review*, vol. 40, pp. 559-567.

⁶¹Jonathan M. Miller. 2003. “A Typology of Legal Transplants: Using Sociology, Legal History, and Argentine Examples to Explain the Transplant Process,” in *The American Journal of Comparative Law*, vol. 51, pp. 839-885.

⁶²*Ibid*, p. 883.

performance, or is there some third factor that affects both the quality of the legal system and economic performance? Does the success of legal reforms depend on the order in which the various elements are introduced? Is it vital for the success of the reform to integrate judicial reforms with informal enforcement mechanisms?⁶³ Stephenson, focusing specifically on U.S. efforts to promote the rule of law in China, voices strong skepticism of the existing literature, suggesting that weak theoretical foundations will contribute to the failure of such initiatives.⁶⁴ Recognizing the inherent flaws in the current body of work, a new stage in the debate on legal reform has been reached in last few years, thanks in large part to the research of Katarina Pistor and her colleagues which is at the cutting edge of legal reform studies.⁶⁵

Understanding Legal Demand: A Central Piece in the Legal Reform Puzzle

Berkowitz, Pistor, and Richard estimate the relationship between (i) legal families and transplant methods and (b) levels of legality, the latter defined as the security of property rights. Employing econometric methods, their study estimates the transplant effect: measuring the success or failure in transferring a legal code from a source country to a transplant country. They measure success via an index of legality which includes: survey data measuring the effectiveness of the judiciary, rule of law,

⁶³Richard Messick. 1999. "Judicial Reform and Economic Development: A Survey of the Issues," in *World Bank Research Observer*, vol. 14, pp. 117-136.

⁶⁴Matthew Stephenson. 2000. "A Trojan Horse Behind Chinese Walls: Problems and Prospects of U.S.-Sponsored "Rule of law" Reform Projects in the People's Republic of China." Working Paper 47. Cambridge: Center for International Development, Harvard University.

⁶⁵Berkowitz, Pistor, and Richard 2003.

the absence of corruption, low risk of contract repudiation and low risk of government expropriation. The basic assumption here is that *domestic demand* for the new legal order is required to make it effective as measured above. They conclude:

“Laws that are compatible with the preexisting social norms are more likely to be well received and thus effectuated. We therefore suggest that legal transplants may work, if they are adapted, or if the population is already familiar with the basic principles of these laws. Our empirical analysis offers strong support for these propositions. Receptive transplants, i.e., those that adapted the imported law, or had a population that was familiar with it show legality ratings that are statistically no different from those of origin countries. Countries without similar predispositions, i.e. unreceptive transplants, perform much worst. These countries suffer from the transplant effect. These findings have fundamental policy implications. They strongly suggest that legal reform viewed simply as technical assistance programs that can be implemented by having Western experts design good laws, are unlikely to produce the desired outcome, i.e. an effective legal order and economic growth and development. Instead, attempts must be made to induce an internal process of law development and to generate a self-sustaining demand for legal innovation and change.”⁶⁶

However, as Markovits points out, these conclusions are problematic.⁶⁷ The authors’ units of comparison do not capture the current process of law reform in the transition economies and the concept of “receptive transplants” simply assumes that the effectiveness of transplanted law is dependent on its willing acceptance by the law’s addressees in the recipient state. Subsequent research within this vein has elaborated the primary problems of legal transplants, namely the stagnation of law and erratic

⁶⁶Berkowitz et al 2000, p.27

⁶⁷Markovits 2004, p. 101.

processes of change.⁶⁸ Nevertheless, Pistor et al conclude that there are multiple potential explanations for the problems which confound the legal transplant process and that the question requires further work. They sum up their most recent article on the subject by calling for future research to more closely analyze the political economy of legal change.⁶⁹ In their view, through such an approach, conclusions as to the causes of success and failure of legal reform can be built on more solid ground. This view is echoed by Kathryn Hendley in her work on the Russian legal system, who has pointed out that what is precisely lacking in the literature are “studies of the process of change,”⁷⁰ as well as in the most recent comparative law literature which has urged increased study of the “dynamic processes of legal change,”⁷¹ and in research setting out the next generation of questions for the study of East Asian law.⁷²

Gray and Hendley have convincingly argued that demand for law among market actors is essential if successful legal reform is to take place.⁷³ Myriad economies have been on the receiving end of “legal supply” but have continued to see minimal utilization of the court system and the maintenance of inefficient informal institutions

⁶⁸Pistor, Keinan, Kleinheisterkamp, and West 2003.

⁶⁹ *Ibid*, p. 109.

⁷⁰Hendley, Kathryn. 2006. “Assessing the Rule of Law in Russia,” in *Cardozo Journal of International and Comparative Law*, vol. 14, pp. 347-391.

⁷¹Horatia Muir Watt. 2006. “Globalization and Comparative Law,” in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law*. New York: Oxford University Press, p. 589.

⁷²Zentaro Kitagawa. 2006. “Development of Comparative law in East Asia,” in Mathias Reimann and Reinhard Zimmermann (eds), *The Oxford Handbook of Comparative Law*. New York: Oxford University Press, p. 257.

⁷³ Kathryn Hendley and Cheryl Gray. 1997. “Developing Commercial Law in Transition Economies: Examples from Hungary and Russia,” in *The Rule of Law and Economic Reform in Russia*, edited by Katharina Pistor and Jeffrey Sachs. Boulder: Westview Press/

as the main locus of dispute resolution. Hendley and Gray contend that legal demand finds its origin in the preferences of market actors for stability: “a desire for objective rules of the game that apply across the board rather than on a case by case basis.” They ultimately argue that this yearning for stability will only be found in those economies where firms are “truly” dependent on the market for survival, i.e. “they no longer view the state as an assured safety net in times of trouble ... In sum, the withdrawal of the state may to a great extent be a sine qua non for the development of the rule of law.” An economy dominated by a few firms with close state ties should, following this contention and as hypothesized in this dissertation, be unable to achieve the rule of law. Conversely, the existence of a more diverse, SME oriented economy would seem to bring significant benefits as regards legal reform.

This point is closely linked to the earlier, “Big Bang” argument for rapid privatization of state industry during the initial reform eras of the transition economy, wherein reforms were implemented based on the expectation that “spontaneous” demand for property rights would naturally follow the state’s divestment of its various industries. Much like the Big Bang approach itself, it is problematic. As Polishchuk and Savvateev (2000) point out:

“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 considerations: first, the protection of the agent’s own assets, which is of course welcomed, and second, protection of the 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.”⁷⁴

In other words, not all market actors will necessarily find the establishment and expansion of a formal, efficient set of judicial institutions to be in their economic interest.

As Murrell has pointed out: “Many firms have origins in old state enterprises. For those firms, the safe harbor of old networks might be more attractive than experimentation with new institutions. Firms emanating from the state sector under cloudy circumstances must avoid legal institutions to prevent disclosure of their dubious history. Firms with soft budgets might find it easier to extract state aid than to construct self-enforcing agreements with customers hence, special characteristics of the transition environment might determine strategies of transactional governance.”⁷⁵ The hypothesis as to the interests of the post-reform, economic hierarchy in Russia seems to be borne out by a cursory reading of the history of post-Soviet judicial reform. However, the precise dynamics have yet to be explored. While accepting the importance of legal demand, this dissertation, to reiterate, asks: Under what conditions is legal demand likely to be created? What types of firms are most likely to create that demand?

⁷⁴ Leonid Polishchuk et al. 2000. *Spontaneous (Non) Emergence of Property Rights*. IRIS Working Paper 241. College Park: University of Maryland.

⁷⁵ Peter Murrell. 2003. “Firms Facing New Institutions: Transactional Governance in Romania,” in *Journal of Comparative Economics*, vol. 31:4.

Additionally, building on Polishchuk and Savvateev's point, if state withdrawal from the market is necessary for successful legal reform, how did states which consistently intervened in the market and supported (either through direct ownership stakes or subsidized credit) manage to build the rule of law? The cases of South Korea (and its state supported *chaebol*), Japan (decades of support from the Ministry of International Trade and Industry to the various keiretsu), ranked 11th and 13th on the World Justice Project's "Rule of Law Index" would seem to falsify this contention or at the very least require us to develop a more nuanced understanding as to its implications. Moreover, it becomes necessary to flesh out the meaning of "market dependence."

This is particularly intriguing for the case of large resource firms. In the post-Soviet sphere (Russia, Kazakhstan), these firms are often one of the primary if not *the* primary source of state revenue. In economies where the majority of GDP is dependent on a few firms, is successful reform ever possible? I contend that diversification of the economy, particularly the expansion of the small and medium sized enterprise sector must be accomplished prior to any policy initiatives focused on legal reform.

Demand for Law and the Economy: Co-Evolution and the Varieties of Capitalism

The study of legal reform in the post-socialist world generally begins with the recognition of the common legal history and legal institutions of the post-socialist economies. I contend that this approach has resulted in masking vital differences across

the landscape of these states and inadvertently continues the tradition of *tabula rasa* understandings of legal reform. Rather than being blinded by the presence of a common set of institutions derived from the socialist era, it is essential to recognize that the process of transition to the market economy has been vastly different across these states and this fact carries significant causal weight as regards the development of the civil judicial system. Foreign investment regimes, comparative advantage, the resource base, and levels of human capital significantly differ across these states. While the shared institutional history provides significant benefits as regards comparison, if dynamic studies of processes of change are to achieve the goal of deeper comparison and the specification of processes resulting in measurably positive legal reform mooted by Hendley,⁷⁶ it is necessary to explore the diverse political economies of these states. I contend that differences in firm size and market power have significant implications for the coordination strategies which firms decide to utilize and their decisions to utilize formal legal institutions (i.e., demand for law).

In the context of the transition economies, and following Murrell's conclusion that the context of transition presents certain unique challenges to judicial reform which are not necessarily present in other less developed states, two aspects of the national economies and their respective economic histories are particularly important: the reform of the state enterprise system and the resource endowment of the country.

⁷⁶ Kathryn Hendley. 2012. "The Puzzling Consequences of Societal Distrust of Courts: Explaining the Use of Russian Courts," in *Cornell International Law Journal*, pp. 538-567.

Recognizing that institutions do not exist in a vacuum and that there exist considerable complementarities between institutions is not a new insight. Thus, this dissertation grounds itself in one of the path breaking works in this area, Hall and Soskice's *Varieties of Capitalism*, and the relatively small legal literature which has begun to build on that approach.

Hall and Soskice's work explores the nature of institutional complementarities across the political economies of the OECD states. National economies are differentiated according to the methods whereby firms and other market actors coordinate their actions, ultimately concluding that the world's developed economies have "clustered" into two distinct forms of modern capitalism: liberal and coordinated market economies. Hall and Soskice determine how these form based on the degree to which firms utilize either market or strategic coordination in order to achieve their goals. The decision by a firm as to whether it should coordinate or work through the market is dependent on the institutional setting. In those states where markets are imperfect and there is significant support for the formation of credible commitments, firms rely more heavily on strategic coordination. Conversely, when markets are fluid and little support is found for those commitments, firms will rely on the market for coordination. Hence, a correspondence is predicted between the institutional configuration of the various sectors of the economy and the type of coordination which firms employ. This approach has been able to successfully explain differences in comparative institutional advantage,

variations in economic performance, and competing responses to global economic integration. Moreover, this line of research makes use of the sort of rich, contextual case studies which are now so necessary in the study of legal reform.

It also supports the approach taken by Milhaupt and Pistor who, building on the work of Dorf and Sabel, argue that instead of viewing legal systems as a fixed endowment for the economy a more useful approach conceives of the law/market relationship as an iterative process of action and strategic reaction, i.e. what they term a “rolling relationship.”⁷⁷ Milhaupt and Pistor point out: “Law and markets react to one another, with human agents and institutional mechanisms mediating between them. Viewing the relationship as dynamic rather than fixed is important because it shifts the focus of inquiry from the “origin” of legal systems to how they change and where they are heading.”⁷⁸ This approach has also been successfully utilized by Clarke, Murrell, and Whiting (2007) in their work on the Chinese legal system which adopts a “co-evolution” approach to understanding the development of law and the economy.⁷⁹

Casper’s work in the Varieties of Capitalism tradition has explored the development of German contract law, highlighting its development in the presence of a strong network of national industry associations which encourage relational contracting and technology transfer, highlighting how institutions in one sphere of the political

⁷⁷ Curtis Milhaupt and Katarina Pistor. 2008. *Law & Capitalism: What Corporate Crises Reveal about Legal Systems and Economic Development around the World*. Chicago: University of Chicago Press. Michael C. Dorf and Charles F. Sabel. 1998. “A Constitution of Democratic Experimentation,” in *Columbia Law Review*, vol. 98:2.

⁷⁸ Milhaupt and Pistor 2009, p. 7.

⁷⁹ Clarke, Murrell, and Whiting 2010.

economy relate to those in other spheres and rejecting the assumption in earlier legal studies literature which has assumed that the “orientation of the law is relatively autonomous from the activities of societal actors.”⁸⁰ He concludes by illustrating how different types of contract support particular forms of firm coordination which influence the development of the law. In the same volume, Teubner looks at the “co-evolution” of law and market behavior. Through a study of the “good faith” doctrine in the United Kingdom, he shows how particular production regimes, i.e. “the institutional environment of economic action (that) organizes the production of goods and services through markets and market-related institutions and determines the framework of incentives and constraints. Production regimes are the 'rules of the game' which govern economic action,”⁸¹ a point directly germane to the question of legal demand.

Pistor has also taken up the Varieties of Capitalism approach, utilizing the CME/LME divide in order to explain differences in the “scope of the state vs. the powers of the individual.” She contends that legal systems serve as coordination devices for social preferences which are “reflected in legal ground rules stipulating who has the power to determine the meaning of contents of private contracts and who may

⁸⁰Teubner 2001

⁸¹ Gunther Teubner. 2002. “Idiosyncratic Production Regimes: Co-evolution of Economic and Legal Institutions in the Varieties of Capitalism,” in John Ziman (ed.), *The Evolution of Cultural Entities: Proceedings of the British Academy*. Oxford: Oxford University Press, pp. 161-182.

seek outside help – judicial recourse – to settle disputes.”⁸²This dissertation, as noted in the previous chapter, adopts and expands on the concept of “co-evolution” elucidated by Teubner and Clarke, Murrell, and Whiting hypothesizing that the demand for law is causally dependent upon the market behavior of firms in the three cases in question⁸³. Legal demand and the subsequent development of the judiciary (measured herein by speed of adjudication, monopoly position, and utilization) in an economy dominated by a small number of large firms is hypothesized to differ from that of an economy with a large SME sector. It is therefore essential to “open up” our understanding of the spectrum of firms operating in these economies today and the role of law. As Clarke, Murrell, and Whiting have noted regarding China:

“The devolution of effective enterprise ownership and decision-making power to local governments, if it is genuine, necessarily means that the central government can no longer resolve disputes simply by issuing commands. The alternative to specific commands is a set of generally applicable rules. The growth of the private sector has the same consequence. Enterprises outside the bureaucratic system have no common superior; some other body must resolve their disputes with reference to the preexisting body of rules. Of course, decentralization, the market, and a private sector do not make these changes inevitable, but they do create demands that can be addressed by legal reforms.”⁸⁴

The end of state socialism did not simply result in the liquidation of the vast network of state enterprises and ministries-acting-as-firms (e.g., the Soviet Ministry of

⁸²Katarina Pistor. 2005 “Legal Ground Rules in Coordinated and Liberal Market Economies,” in Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda and Harald Baum (eds), *Corporate Governance in Context*. Oxford: Oxford University Press.

⁸³ Clarke, Murrell, and Whiting 2007.

⁸⁴ Clarke, Murrell, and Whiting 2010, p.

Gas, today the mega-firm Gazprom) which were the hallmark of the Soviet economy before reform. Russia and Kazakhstan each took markedly different approaches to state enterprise reform and broader economic reform in general. The type of firms which has developed since the advent of reform and the relationships which have developed between business and government have differed across these economies. The weakness of the SME sector in Russia and to an even greater extent in Kazakhstan has been constantly noted in studies of the two states. This fact is particularly salient as regards the question of “co-evolution” of law and market behavior.

The general assumption in the literature on institutional reform in the former Soviet Union is that private actors with significant market power and access to alternative means of dispute resolution (i.e., private security, more commonly understood as “hired thugs”) generally prefer less efficient institutions and therefore support the existing set of weak institutions. When the concentration of market power and property is high, market actors will prefer weaker formal institutions in that they are able to purchase private protection (“*krisha*” in the Russian and Kazakh context) and gain advantages over other actors. The existing set of inefficient rules is relatively profitable for market dominant firms in that the rents gained are higher than the losses from transactions costs. Thus as these groups possess a great deal of political power, they are assumed to *actively* block any initiatives to improve the quality of formal legal institutions.

Rather than understanding institutional outcomes as stemming from direct influence over institutional design or as an outcome of various conflicts, when the success or failure of judicial reform is conceptualized as being dependent on legal demand, firms with sufficient market power are able to *passively* block attempts at legal reform through simple maintenance of their dominant position in the economy and the undermining of a competing SME sector thereby precluding the development of the demand for law and further development of the civil court system. The chapters that follow set out the causal dynamics resulting in diverse levels of legal demand in Russia and Kazakhstan.

Chapter Three

Of Arbitrazh and Private Arbitration in Kazakhstan: FDI, Market Power, and the Undermining of Legal Demand

Introduction:

Kazakhstan has been a regional outlier in terms of economic performance, yet maintains a judicial system that remains mired in the same low scores and with the same poor performance of many of its neighbors. The existence of a state with minimal protection of property rights that has managed to climb the ladder to the status of a lower middle income economy presents something of a paradox to the existing understanding of the relationship between development and the rule of law/protection of property rights. Even more intriguing, while Russia's court system has seen marked improvement in recent years, Kazakhstan's has not managed to develop in tandem with the growth of its economy and its ever improving level of human development (IMF estimated 2014 nominal GDP per capita at \$12,184, with the HDI score rising from .686 at independence to .757 in 2014). Today, the country has fewer than 10,000 lawyers, only 10-15 corporate law firms, and the Kazakhstan Bar Association was only established in 2012.⁸⁵ The demand for law remains minimal – why? A country such as Kazakhstan that has experienced such significant growth should see the demand for law increase as the economy expands and as contractual disputes become more complex, yet this has not taken place. It is precisely this surprising outcome which

⁸⁵ Устав РОО. 2012. “Коллегия коммерческих юристов.” <http://www.thelawyer.kz/docs>. (Accessed: September 3, 2015)

makes Kazakhstan such a salient case for the study of legal reform in general and legal demand in particular.

To reiterate the primary argument of this dissertation: in economies dominated by large firms with significant market power, there will be a low level of legal demand and a concomitantly weak judiciary. The causal mechanisms whereby these firms have such a negative impact on the demand for law are threefold: (i) through control of credit via pocket banks which act primarily to provide credit to those firms' smaller subsidiaries and other entities in which stakes are maintained; (ii) through political ties to the judiciary, which in civil matters results in a positive ruling for large, state-connected firms in disputes with smaller firms undermining trust in the courts; and (iii) through the extensive utilization of "second best" options for dispute resolution by SMEs as an alternative to the state courts, namely private arbitration tribunals which act as a drain on legal demand.

I hypothesize that the structure of the Kazakh economy (particularly the gross inequalities in market power across the economic landscape) developed through massive inflows of FDI to a small number of resource conglomerates has facilitated a stable equilibrium of "commercial order without state supplied law"⁸⁶ (to paraphrase

⁸⁶ Robert Ellickson. 1994. *Order without Law: How Neighbors Settle Disputes*. Cambridge, MA: Harvard University Press. Where Ellickson's study of the Shasta region of California points out the benefits of private order, in Kazakhstan the developing system of private arbitration entails higher costs and is not understood here as an optimal solution. Rather, as noted in chapter 4, it is seen as a useful, temporary solution to the problem of contract adjudication until the structure of the economy shifts away from domination by the Big Ten resource conglomerates and significant state control over the economy.

Ellickson). The consolidation of the Kazakh economy in the 1990s, which followed the privatization of the country's vast natural resources together with a massive inflow of foreign direct investment, facilitated the development of a now ubiquitous system of private commercial arbitration at the expense of the state economic court system, which has remained weak and under-utilized. The domination of the Kazakh economy by a small number of firms with close ties to the state has undermined the demand for law thereby limiting the effectiveness of the legal supply initiatives taken by various development agencies and precluding further development of the courts.

The neighboring Russian Federation experienced a similar "run to arbitration" in the 1990s as its system of state economic courts remained stuck in a morass of incompetence and corruption, yet by the early 2000s had turned something of a corner.⁸⁷ If Russia could move toward a workable formal legal system, why has Kazakhstan been unable so to do? Again, the answer lies with the question of market power and FDI. I contend (here and in chapter three) that the diversification of the Russian economy through the development of the SME and non-state industrial sectors facilitated the legal demand necessary to utilize the supply of law and to improve judicial quality, while the continued dominance of large scale, resource conglomerates – developed through massive overseas investment - has impeded this process in Kazakhstan. Specifically, SMEs have been crowded out owing to extensive vertical integration on the

⁸⁷ Kathryn Hendley. 2006. "Assessing the Rule of Law in Russia," in *Cardozo Journal of International & Comparative Law*, 14:2, pp. 347-91.

part of large firms with control over access to capital (the country's banks are in many cases divisions of these firms). Moreover, the close political linkages between resource exporting conglomerates and the state has further served to undermine demand for law through court judgments grossly biased in favor of resource firms with state ties ultimately undermining trust in the judiciary and the demand for law. While the differences between the Kazakh and Russian legal systems are of use in providing support for the hypotheses presented here concerning legal demand, the core of this chapter is devoted to exploring variation within the Kazakh case, looking at the differing levels of market concentration and legal demand across the country's economically diverse provinces.

The firms that dominate the Kazakh economy are not simply the legal successors to Soviet-era industries as was the case in Russia where, for example, Gazprom was created out of the communist era Ministry of Natural Gas and prior to re-nationalization in 2005 relied on western bond and equity markets for investment.⁸⁸ Rather, Kazakh firms were uniquely dependent on FDI and joint ventures with western firms. Absent this FDI, the concentration of the economy seen today would not have taken place. The scale of foreign investment in Kazakhstan and the subsequent withering away of the pre-reform industrial sector has had direct implications for the SME sector. Additionally, the influx of FDI had indirect effects as well, most notably in

⁸⁸ Andrey Vavilov. 2014. *Gazprom: An Energy Giant and Its Challenges in Europe*. London: Palgrave Macmillan.

effecting changes to the legislation governing private arbitration and the enforceability of private arbitral awards. In 2004, the government of Kazakhstan passed the “International Arbitration Law” (Republic of Kazakhstan Law 23-III) and the “Domestic Arbitration Law” (Republic of Kazakhstan Law 22-III) following a year of lengthy contestation during which the Ministry of Justice opposed provisions that would allow for the enforcement of arbitral decisions through the bailiff powers of the courts. In the course of several interviews conducted at Kazakhstan International Arbitration, the pressure of foreign investors on the government to support enforcement was consistently noted as a major driver of these new regulations that would resolve the problems of enforcement which had bedeviled the private tribunals since their inception.⁸⁹

The undermining of the demand for law has taken place in tandem with the expansion of informal systems of dispute resolution, i.e. private arbitration chambers (such as Kazakhstan International Arbitration referenced above) that find their origin in the Soviet state arbitration system. Unlike Russia where state arbitration was converted into a system of economic courts almost immediately following the establishment of the Russian Federation, the process in Kazakhstan only began several years later, following the privatization of industry.⁹⁰ While state arbitration was technically abandoned in

⁸⁹ Interviews at Kazakhstan International Arbitration with M. K. Suleimenov, chair of KIA in May 2010.

⁹⁰ Kathryn Hendley. 1998. “Remaking an Institution: The Transition in Russia from State Arbitrazh to Arbitrazh Courts,” in *American Journal of Comparative Law*, vol. 46:1, pp. 93-127. Martha Brill Olcott. 2010. *Kazakhstan: Unfulfilled Promise*. Washington DC: Carnegie Endowment for International Peace.

favor of a modern, civil law system, the remains of that system: the body of legal consultants, arbitrators, and attorneys remained – providing an alternative to the new set of economic courts. Grounded in the research of Kathleen Thelen and Wolfgang Streeck on the political economy of institutional reform, I set out this process of “institutional transfer” in which state arbitration lost its role as the official commercial legal institution of the state but was reconstituted as a diverse set of private dispute resolution/mediation entities.⁹¹ Their role has been something of a double edged sword. On the one hand, these entities have acted as a consistent drain on legal demand and have been a source of considerable political conflict in the country. Nevertheless, while weakening the legal demand necessary for the development of the economic court system, these institutions have managed to provide certain benefits to the SME sector in the form of fair contract adjudication procedures. The expansion of these entities raises new questions for the political science and development literatures as to the role of “second best” institutions in the development of legal systems and their role in buttressing long term economic growth.

The implications of FDI in Kazakhstan and the concentration of its economy have been a type of vicious circle. Kazakhstan finds itself stuck in an institutional low level equilibrium trap. The firms that drive its stunning GDP growth and serve as the primary source of state revenue continue both directly and indirectly to undermine the

⁹¹Streeck and Thelen 2009.

development of formal legal institutions that impede the growth of the SME sector further hampering growth in the demand for law. Ultimately, this has locked the country into a sub-optimal equilibrium.

Kazakhstan has been on the receiving end of significant technical assistance from various bilateral and multilateral aid agencies, i.e. the supply of law. Beginning in 1993 USAID began providing technical assistance supporting the development of commercial law and the economic courts, this assistance is ongoing with USAID activities as of 2006 jointly funded by the American and Kazakh governments.⁹² The EBRD has funded programs in support of the development of the judiciary and has strongly focused on the legal framework to support the development of the country's financial markets.⁹³ The World Bank's work in Kazakhstan began with \$16.5 million loan to strengthen the courts, access to legal information, improvements in legal education, and enforcement of judicial decisions.⁹⁴ This supply of law has not had the anticipated effects, i.e. legal demand remains weak and economic actors continue to utilize venues other than the economic courts to resolve contractual disputes. Kazakhstan is the paradigmatic case of a state where legal supply has been unable to overcome the absence of legal demand. If further support for judicial reform is to

⁹²*Kazakhstan Business Law Handbook, Volume 1: Strategic Information and Basic Laws*. Washington DC: International Business Press.

⁹³ EBRD. 2014. *Kazakhstan Transition Report: Progress in Structural Reforms*. London: EBRD.

⁹⁴ World Bank. 1998. *Project Appraisal Document on a Proposed Loan to the Government of Kazakhstan for a Legal Reform Project*. Report 18792-KZ. Washington DC: World Bank.

continue, it is necessary to determine the causality behind legal demand, making the topic of this dissertation particular relevant.

The chapter is structured as follows: (i) a summary of the transition of the Kazakh economy and its outcomes as regards the structure of the national economy; (ii) a discussion of the role of FDI and its implications for the development of the country's ten largest firms and the SME sector; (iii) an exploration as to the development (or lack thereof) in the SME sector and the usage of law; (iv) a framework for understanding the role of state-business ties in Kazakh politics; and (v) an examination of the development of the Kazakh judicial and arbitration systems since independence in 1991 and the weakness in legal demand.

Economic Transition in Kazakhstan: Towards a Highly Concentrated Economy

Throughout the existence of the Soviet Union, Kazakhstan remained something of a backwater – an exceedingly large and arid backwater. Until the 1950s, its economy remained dominated by agriculture and pastoral activities and served primarily as a location in which to dump those groups deemed undesirable by the Stalinist state: ethnic Germans, Chechens, Ingush, Koreans, and others whose presence in their home regions was deemed a threat to Soviet security.⁹⁵ Modern economic development began only in the late 1950s, with the opening up of the northern portion of the republic to

⁹⁵ Martha Brill Olcott. 1997. "The Central Asian States: An Overview of Five Years of Independence," in *Demokratizatsiya*, vol. 5:4, pp. 522-528. Robert Conquest. 1970. *The Nation Killers: The Soviet Deportation of Nationalities*. London: Macmillan.

new agricultural production as part of Khrushchev's "Virgin Lands Campaigns" and the discovery of the territory's substantial and diverse resource base; however, it was minerals rather than oil and gas which dominated. By 1989, Kazakhstan produced 19% of all coal and 10% of all iron ore in the USSR, accounting for a rather miniscule 4% of Soviet crude oil production. Deeply integrated into the Soviet division of labor system, inter-republic exchanges accounted for 86% of total trade with over half directed towards the Russian republic.⁹⁶ This was facilitated by a transport infrastructure designed to support Moscow's extensive growth model and Russian industry's constant need for increased inputs. Pipeline routes ran to the north but barely connected eastern and western Kazakhstan. The country's mineral wealth was tied to a series of "company towns" dependent on production chains involving suppliers, smelters, and end users in Russia and other parts of the USSR.

For example, while the oil industry in the west of the country was dependent on pipelines to Russia, Kazakhstan's own refineries in the east (Pavlodar) and the south (Shymkent) were linked to the oil fields of Siberia (see map 3.1 below for reference). Kazakhstan's deep integration with Russia might serve to explain its passive and even hostile attitude towards independence. While Tatarstan and the Baltic republics led the so-called "parade of nationalities" pushing for sovereignty, Almaty

⁹⁶JürgenWandel and BotagozaKozbagarova. 2009. *Kazakhstan: Economic Transformation and Autocratic Power* Mercatus Policy Series, Country Brief No. 4. Available at SSRN: <http://ssrn.com/abstract=1434522> or <http://dx.doi.org/10.2139/ssrn.1434522>

remained unconvinced.⁹⁷ In March 1990 a new Supreme Soviet was elected for the republic with

Figure 3.1: Political Divisions of Kazakhstan⁹⁸



Communist party secretary NursultanNazarbayev voted in as its first president. Independence was not part of his program; rather he raised the banner of Perestroika and supported maintaining the unity of the USSR. Following Mikhail Gorbachev’s call for a referendum on the continuation of the Soviet Union, Nazarbayev was prominent in the “yes” campaign and supported a treaty which would create a new union of sovereign republics.

⁹⁷ Mark Beissinger. 2002. *Nationalist Mobilization and the Collapse of the Soviet State*. Cambridge, MA: Harvard University Press.

⁹⁸ Non-copyrighted, publicly available map of Kazakhstan, accessed August 2015: <https://en.wikipedia.org/wiki/Kazakhstan>

Following the short lived October 1991 coup which temporarily ousted Gorbachev, Nazarbayev continued to work with other republic leaders to maintain the union. Events outpaced him. To paraphrase Shakespeare, some countries declare independence while others have independence thrust upon them. For Kazakhstan, independence came by telex from a conference in Minsk, a *fait accompli* decided by the leaders of Russia, Ukraine, and Belarus which finally forced Kazakhstan to declare independence on December 6, 1991. It was the last republic to do so with Nazarbayev continuing to call for the maintenance of the union for nearly a week following the declaration, an historically unique position for an individual now widely termed “the father of Kazakhstan.”⁹⁹

If Kazakhstan was kicked out of the Soviet nest, the discovery of new oil and gas fields in the early 1990s served to salve some of the pain that resulted from its fall. The country suddenly became the holder of the world’s 11th largest proven oil and natural gas reserves and a magnet for FDI.¹⁰⁰ This was in addition to the second largest uranium, chromium, and lead reserves; the fifth largest copper reserves; and a long list of other resources; remarkably, 99 of the 110 elements in the Periodic Table are present in the country.¹⁰¹ Despite this material abundance, the disintegration of the Soviet Union had severe implications for the country’s economy: supply and demand links

⁹⁹ A commonly used term across both the popular press, state propaganda, and across media in country.

¹⁰⁰ Paul Rivlin. 2014. “Oil and Gas in the Economies of the Caspian Region,” in Moshe Ganner (ed) *The Caspian Region Volume I: A Re-Emerging Region*. London: Routledge Press.

¹⁰¹Wandel and Kozbagarova 2009, p. 11.

were disrupted, contributing to a substantial decline in GDP in an economy almost totally dominated by mining, metallurgy, and wheat production.¹⁰² As Franke has noted, the non-resource sectors of the economy were disproportionately damaged by the collapse. Economic policy in 1992-94 was driven by the perceived need to maintain economic integration with Russia, with Kazakhstan following radical, Big Bang reforms similar to those adopted by Moscow, i.e. rapid price liberalization and privatization.¹⁰³ The privatization process began with a voucher system modeled on the Russian and Czech models that devolved into a series of asset sales to investment privatization funds which had accumulated most of the vouchers, with the state divesting itself of most major assets by 1996.¹⁰⁴

Privatization ultimately determined the initial structure of the post-socialist Kazakh economy with the most notable innovation being the establishment of a set of vertically integrated conglomerates controlling multiple aspects of the production process, i.e. financing, capital, and manufacturing. By the late 2000s, just ten of these firms would control *four-fifths* of the Kazakh economy.¹⁰⁵ In order of size, they are: KazMunayGaz (KMG), KharrkiyeKukmol' Munay, Shymkentnefteorgsintez, KEGOK, TemirtauMitalStil, KorporaciyaKazakhmys, Kazzinc, Alyuminiy Kazakhstan,

¹⁰² Anja Franke. 2010. "Kazakhstan and Azerbaijan as Post-Soviet Rentier States: Resource Incomes and Autocracy as a Double 'Curse' in Post-Soviet Regimes," in *Europe-Asia Studies*, vol. 61:1, pp. 109-140.

¹⁰³ Boris Najman, Richard Pomfret, Gael Raballand and Patricia Sourdin. 2005. "How are Oil Revenues Redistributed in an Oil Economy? The Case of Kazakhstan," School of Economics Working Papers 2005-18, University of Adelaide, School of Economics.

¹⁰⁴ Olcott 2010, p. 260.

¹⁰⁵ Richard Pomfret. 2009. "Using Energy Resources to Diversify the Economy: Agricultural Price Distortions in Kazakhstan," in *Comparative Economic Studies*, vol. 51(2), pp. 181-212.

KazKhrom, and Ust' Kamenogorskiy Titano-Magnievnyy Kombinat. It is these ten firms and their dominant position in the economy which will be examined below. The banking sector has also played a particularly prominent role, another outcome of the early transition years when these firms (following the example of their Russian peers) established their own "pocket banks." Comparatively, these sorts of large scale, integrated conglomerates are not unique. Structurally they are similar to the *keiretsu* of Japan and the *chaebol* of South Korea. Aslund has noted business groups such as these in the post-Soviet economies and has argued that they are "nothing but normal" at this point in a country's economic development, comparing their development to the late 19th century industrial empires of Rockefeller (Standard Oil), Morgan (US Steel), and other so-called "robber barons."¹⁰⁶

However, the effects of the conglomerates of Kazakhstan and the conditions in which they grew were different. U.S. firms developed after the formal judicial system had been institutionalized for decades; while the Japanese and South Korean corporate giants were neither resource based nor did they crowd out the development of SMEs. In the case of South Korea, the development of the *chaebol* occurred relatively late, expanding only after the implementation of the Heavy and Chemical Industry Plan of

¹⁰⁶ Anders Aslund. 2002. *Building Capitalism: The Transformation of the Former Soviet Bloc*. Cambridge: Cambridge University Press.

the late 1970s and operating in a diverse marketplace which had developed in earlier decades as part of the country's export oriented industrialization program.¹⁰⁷

Aslund observed certain commonalities which contributed to the development of this form of industrial organization, i.e. significant economies of scale in certain industries (oil and metals in particular) and rapid structural change.¹⁰⁸ The formation of these firms during the 1990s must be viewed in the context of the absence of formal institutions to monitor trustworthiness, the need to engage in arms-length contracting, and the importance of establishing supply and marketing links as well as access to capital. Wandel has demonstrated how principal-agent problems facilitated this type of consolidation.¹⁰⁹ The question as regards linkages to the state (discussed in the following section) has consistently hung over the heads of these firms. Kjaernet, Satpaev, and Torjesen have contended that deep relationships with government elites have been ubiquitous for Kazakh firms in the natural resources, banking, and agricultural sectors with high profit margins.¹¹⁰ While in other cases (e.g., KMG, Eurasian Resources, etc.) the state either wholly owns or maintains a stake in the firm.

A series of exogenous shocks – most notably a collapse in oil prices and the 1998 Russian financial crisis – prolonged the country's initial economic stagnation. Following a devaluation of the national currency, the *tenge*, the economy of Kazakhstan

¹⁰⁷ Meredith Woo-Cummings. 1999. *The Developmental State*. Ithaca: Cornell University Press.

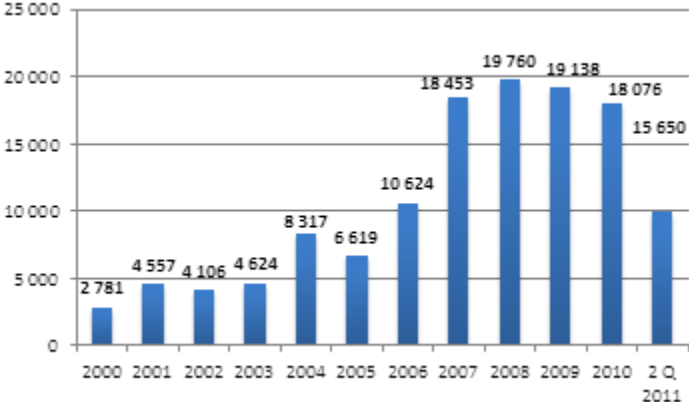
¹⁰⁸ Aslund 2005, p. 42.

¹⁰⁹ Summarized in Wandel and Kozbagarova 2009, p. 24.

¹¹⁰ H Kjaernaet, et al. 2008. "Big Business and High-level Politics in Kazakhstan: An Everlasting Symbiosis?" in *The China and Eurasia Forum Quarterly*, vol. 6:1, pp. 95-107.

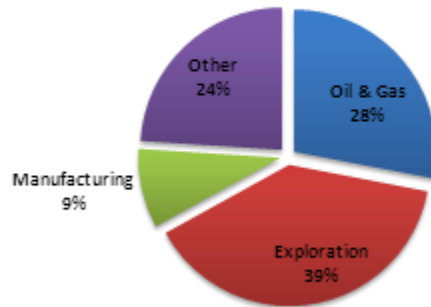
stabilized and by 2001 began to experience rapid growth. This growth has been attributed primarily to the “Big Ten” resource firms which have benefited from significant FDI (see figure3.2 from the Kazakhstan Ministry of Industry below) and overcame the challenges of discrimination against Kazakh oil by the Russian firms that controlled the Soviet era pipeline infrastructure. The Russian state owned firm, Transneft, consistently engaged in monopsonistic practices (e.g., arbitrary long route allocations and arbitrary assessments of technical losses) and only with the opening of the first privately owned pipeline in 2001 did an alternative route become available. Since that time the economy has been dominated by the resource sector, i.e. the ten major conglomerates which control it along with a few joint foreign ventures (e.g. the Chevron led Tenghiz oil field project in the west of the country).

Figure 3.2: Kazakhstan FDI Totals and Structure (in USD millions) by Sector¹¹¹



¹¹¹ Tables from data from the Kazakhstan Ministry of Industry published in 2012 KazInvest Report on FDI in Kazakhstan. Kazakhstan Ministry of Commerce. 2012.

FDI Structure, 2000-2010



The government has made half-hearted attempts at economic diversification, announcing in 2003 a set of priority areas with linkages to the oil sector and various high value-added sectors (i.e., space and nuclear technology). These have not been successful. As illustrated in the above figure from the 2012 Kazinvest report prepared by the Kazakhstan Ministry of Industry, foreign investment has been overwhelmingly directed to the resource sector and the small number of firms which dominate that sector. As noted in the 2013 EBRD Kazakhstan country strategy paper, in recent years the hydrocarbon sector alone (independent of the broader resource sector) accounted for approximately 25 percent of GDP, 60 percent of total exports, and about 40 percent of total budget revenues.¹¹² Moreover, 67 percent of cumulative FDI inflows went to the oil and gas/resource exploration industries by the end of 2010.¹¹³ The SME sector for the same year contributed only 14.3% of GDP, a *decline* from 18.7% in 2005. Kazakhstan is, by any standard, an economy where SMEs maintain little to no market power and an

¹¹² European Bank for Reconstruction and Development. 2013. *Transition Report 2013: Stuck in Transition?* London: EBRD.

¹¹³ European Bank for Reconstruction and Development. 2014. *Kazakhstan: Transition Report*. London: EBRD.

incredibly weak position relative to the “Big Ten” conglomerates which continue to dominate all aspects of the economic life of the country. The figures are even more remarkable when compared to the contributions of the SME sector in Germany (57% of GDP), the United States (52%), and Canada (43%).¹¹⁴

FDI in Kazakhstan: Structuring and Centralizing the Post-Soviet Kazakh Economy

The United Nations’ Commission on Trade and Development (UNCTAD) statistics indicate that worldwide FDI inflows were about US \$200 billion in 1990 and began rapidly increasing in the late 1990’s to \$1.4 trillion in 2000. From 2001 to 2005 FDI inflows fell back below the trillion dollar level.¹¹⁵ Indeed, competitive pressures and searches for new growth opportunities led to an FDI outflow from developed countries consisting of \$745 billion in 2005; firms from developed countries accounted for about 87 percent of these outflows. The strongest explanations for the renewed surge in FDI have been competition and price appreciation for natural resources. According to UNCTAD, FDI remains the primary source of capital for developing countries and “continues to surpass other private capital flows to developing countries as well as flows of official development assistance programs” that accounts “for more than half of all resource flows to developing countries”. Earlier issues of the World Investment Report suggested that FDI flows would continue to increase and indeed they peaked in

¹¹⁴ Asian Development Bank. 2014. *Industrial Transformation in the People’s Republic of China: Challenges and Recommendations*. Manila: Asian Development Bank.

¹¹⁵ United Nations Commission on Trade and Development. 2010. *World Investment Report*. New York: United Nations.

2007 at \$2.1 trillion before the financial crisis led to reductions in 2008 and 2009 (World Investment Report, 2010). Kazakhstan's FDI inflows are similar to the global trend. Between 1994 and 2002 FDI inflows to Kazakhstan increased in most years. In 2008 (see figure 2.2) FDI inflows to Kazakhstan peaked at \$14.3 billion.¹¹⁶ In total, since its independence in 1991, Kazakhstan has received over \$50 billion of FDI inflows.¹¹⁷

Since 1993 Kazakhstan has on average received FDI amounting to about 7.5% of GDP and peaked at over 12% in years 2001 and 2009. The FDI inflows have been volatile in nature and as Waikar has noted and as figure 2.2 indicates, FDI inflows have been primarily directed towards large, resource firms.¹¹⁸ Following the collapse of the Soviet Union, the traditional, established Russian markets for Kazakhstan's mining and metallurgical output disappeared. As a result, resource output declined and these enterprises experienced severe financial pressure. Beginning in 1997, in an attempt to redress the situation the government either privatized or awarded "management contracts" for many of the enterprises to consortiums of local and foreign investors.

The government subsequently passed a body of legislation in 1997 governing FDI: "On state support in favor of direct investments," "On the securities market," and "On registering transactions with securities." In addition, Astana concluded several bilateral agreements aimed at improving the reciprocal protection of investments. It is

¹¹⁶ World Investment Report 2010.

¹¹⁷ National Bank of Kazakhstan. 2013. Годовой отчет Национального Банка Республики Казахстан за 2013 год. Astana: National Bank of Kazakhstan.

¹¹⁸ Avinash Waikar. 2011. "Impact of Foreign Direct Investment on Kazakhstan's Economy: A Boon or a Curse," in *International Journal of Business and Social Science*, vol. 2:22, pp. 92-98

essential to note that Kazakhstan's body of regulation governing FDI has been categorized as "Fully Open," a distinct approach to FDI in which investment can be made in practically any economic activity and utilizing a myriad of organizational approaches up to an including the creation of foreign firms and joint ventures with local companies.¹¹⁹Dosmukhamedov has examined the adoption of this form of FDI regulation in Kazakhstan, placing it within a broader typology of FDI in the transition economies and highlighting the impacts of this regulatory regime as regards the subsequent development of the resource sector. Concerning economic diversification in Kazakhstan, the outcomes have clearly been negative – as illustrated by the weak state of the SME sector. The financial crises in Asia and Russia between 1997 and 1999 further depressed markets for Kazakh mineral products. It is in that context that the privatization program and "open investment" approach to FDI laid the basis for the Kazakh economy we know today. Production ultimately stabilized and these enterprises have significantly expanded. It is useful to examine the role of FDI in the expansion of several of the "Big Ten" firms.

Kazzinc is the country's main producer of lead, zinc, gold and silver - one of the largest producers in the world. Controlling five mines, three mills and two zinc plants with a total capacity of about 260,000 ton of metal, it also owns a zinc plant with a capacity of 160,000 ton as well as sulphuric acid production plants, refining and rare

¹¹⁹E.K. Dosmukhamedov. 2010. *Foreign Direct Investment in Kazakhstan. Politico-Legal Aspects of Post-Communist Transition*. London: Palgrave.

metal production plants, service plants and other infrastructure. The total number of staff is about 26,000. It was formed in 1997 by the Swiss firm, Glencore, through a merger of three major mining and metallurgical companies, the Ust-Kamenogorsk Lead and Zinc, LeninogorskPolymetal and Zyryanovsky Lead. Glencore has invested about US\$65 million in the opening of a new mine at Maleyevsky, and through its subsidiary Kazastur Zinc AG, Glencore subsequently provided additional investment of \$190 million to increase production in the near term.¹²⁰

Kazakhstan's major copper manufacturer is Kazakhmys, located in Zhezkazgan in central Kazakhstan. Samsung maintains a 40% stake in the firm. Kazakhmys is the umbrella company for the country's copper enterprises, the Karaganda open-cast coal mines, three power stations and six refining plants. Since Samsung became involved in Kazakhmys, it "has made large investments in the industry, including equipping the Zhezkazgan mine with state-of-the-art technology at a cost of over US\$120 million to turn it from a start-up mine into a producer" with a subsequent investment of \$300 million according to the EBRD's Kazakhstan Investment Profile.¹²¹ In 1998, KazChrome the country's largest chromium company was taken over by Japan Chrome. The latter purchased a controlling 55.2% stake in the company. The firm is headquartered in Aktubinsk and owns two ferro-chromium alloys plants, Ermak and Asku, the

¹²⁰Waikar 2011, p. 94.

¹²¹ European Bank for Reconstruction and Development 2013. *Kazakhstan Investment Profile*. <http://www.ebrd.com/downloads/country/strategy/kazakhstan-strategy-2013.pdf>

ownership and management was subsequently taken over by the (domestic) Eurasia Bank Group.

This investment has shown significant results: Kazakhstan's export volume in 1995 accounted for 31 percent of GDP, this share increased to 50 percent over a ten year period. The export composite includes durable and non-durable goods. Out of the non-durable share of exports, mineral products made up 29 percent in 1995 and increased to 74 percent in 2005. As Waikar has demonstrated, exports did not increase and in fact declined in the manufacturing, agriculture, construction and sectors where it was found that employment also declined.¹²² In contrast, in the state-linked industries of transportation and natural resources overall employment increased during the observed period indicating an economy led by its resource sector in addition to the state-owned transportation and communications infrastructure with much of that growth funded by the revenues generated by the "Big Ten" resource conglomerates. The vast expansion of these firms via FDI has resulted in an extreme concentration of market power in a very small number of firms which, following Pomfret, control 80% of the national economy.¹²³

¹²²Waikar 2011, p. 96.

¹²³Richard Pomfret. 2013. "Kazakhstan's 2030 Strategy: Goals, Instruments and Performance," paper presented at the American Economic Association annual conference on 4 January 2014 in an Association for Comparative Economic Studies panel on Kazakhstan's Economic Strategy: Halfway to 2030.

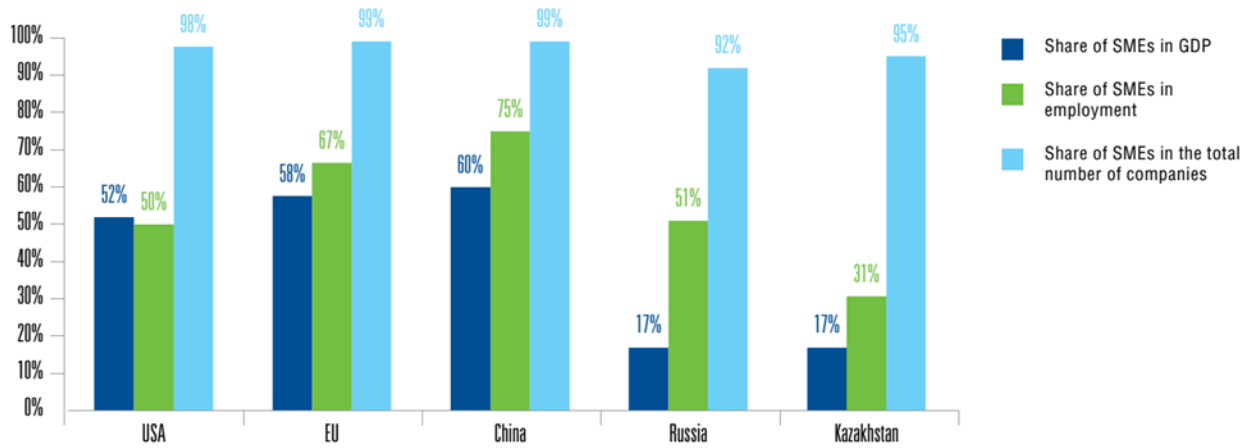
Weaknesses in the Small and Medium Sized Enterprise Sector

Gans-Morse has illustrated how the expansion of the SME sector has positive effects for the development of judicial systems in the transition economies.¹²⁴ Unfortunately by virtually all measures, the SME sector in Kazakhstan remains severely underdeveloped – not having benefited from FDI and as will be discussed below, severely starved of capital. In 2013, the sector contributed only 17.8% of GDP and employed less than 30% of the country’s labor force, a remarkably low figure when placed in comparative perspective. Of the 301,200 small businesses registered to operate in the country, only 56.5 percent are active concerns, and this number continues to decrease (see figures 3.3 and 3.4 below).¹²⁵ Two causal factors have been put forward in the existing economic and policy literature to explain this lack of development: (i) Dutch Disease and (ii) lack of access to capital. Both are direct outcomes of the continued dominance of the economy by the FDI-facilitated “Big Ten” corporations. It is the second of these, the lack of access to capital (specifically, the dominant role played by the same, “Big Ten” firms that has undermined financing for the SME sector in Kazakhstan.

¹²⁴ Jordan Gans-Morse. 2011. ““Building Property Rights: Capitalists and Demand for the Rule of Law in Russia,” unpublished dissertation, Department of Political Science, University of California-Berkeley.

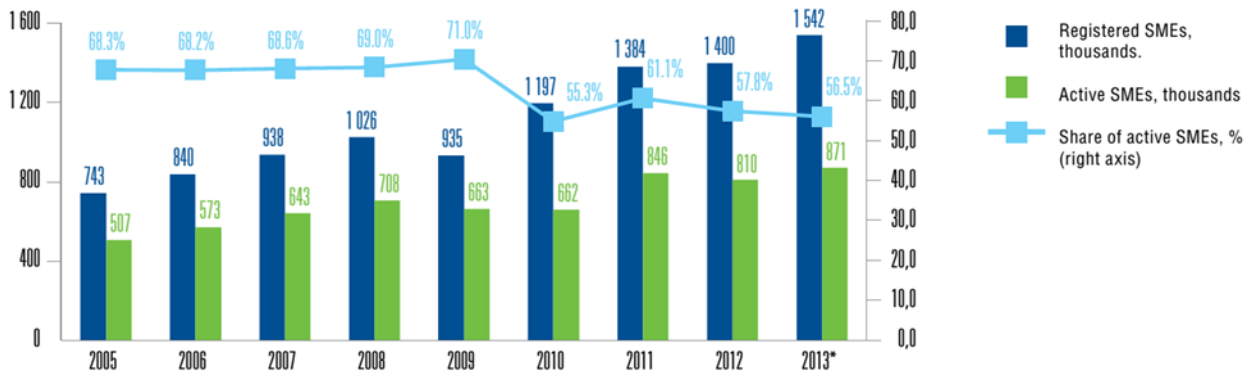
¹²⁵ Kazakhstan Ministry of Industry. Additional charts and data from the Kazakhstan Ministry of Commerce. <http://dep-ecointeg.mid.gov.kz/ru/kategorii/promyshlennost>

Figure 3.3: SME Sector's Share of Total GDP¹²⁶



Note: Drawn up based on the data from various sources

Figure 3.4: Registered vs. Active SMEs¹²⁷



Note: Drawn up based on the data of the RK Statistics Agency (www.stat.gov.kz)
 *2013 data is based on the latest information currently available

While the banking sector in Kazakhstan is significantly more developed than in the other Central Asian states, credit has gone disproportionately to the construction and real-estate market, particularly in Astana and Almaty. In 2005, construction credits amounted to 12.8% of bank loan portfolios, by 2007 that figure had risen to 25.6%. The

¹²⁶ All figures related to the question of SME development in Kazakhstan are from the Kazakhstan Ministry of Commerce and the Kazakhstan Ministry of Industry. 2014. (These were not created independently by the author)

¹²⁷ See footnote 135.

Asian Development Bank has estimated that over 70 percent of all loans were directly or indirectly linked to the real estate sector, compared to 25 percent in Russia where a much greater share of lending has been directed towards the SME sector. It is also essential to note the miniscule role that the SME sector plays in the construction sector, accounting for only 3% of SME activity as noted in figure 3.5. Kurulbayeva and Vines have noted that the directing of the vast majority of investment towards the construction/real estate sector is due to rising household incomes stemming from the rapid growth of the country's resource sector – together with (i) a genuine need for new housing in light of the under-supply and low quality of that which was inherited from the Soviet era and (ii) the lack of alternative locations for investment by the general public owing to the underdeveloped securities market.¹²⁸ The realities of Kazakhstan's banking sector, specifically the high levels of concentration and lack of competition, have been clearly explored in recent IMF research.¹²⁹ In order to determine the level of concentration of banks, a Herfindahl-Hirschman Index is utilized that reveals a highly concentrated banking system. Across the countries 34 banks, an even distribution of assets, loans, and deposits should, according to IMF estimates, result in an index score of 294. The actual indices coming in at 1,402, 1,509, 1,462, and 1,645 for assets, loans,

¹²⁸KarylgashKuralbayeva and David Vines. 2006. "Terms of Trade Shocks in an Intertemporal Model: Should We Worry about the Dutch Disease or Excessive Borrowing?" CEPR Discussion Papers 5857, C.E.P.R. Discussion Papers.

¹²⁹ IMF. 2013. *Republic of Kazakhstan – Financial Sector Assessment Program Update – Bank Profitability and Competition*. Washington, DC: IMF.

deposits, and personal deposits respectively,¹³⁰ a deviation of 250, 282, 256, and 459 percentage points from an even distribution. Over 80 percent of assets, loans, and deposits were held by the ten largest banks, with 61 percent of assets and 66 percent of loans held by the three largest.¹³¹ Of the latter group, each of these is (as noted below) tied to one of the “Big Ten” industrial conglomerates. USAID, in its research exploring regional economic inequality noted that strong correlation between availability of credit and economies with relatively minimal resource sectors: “The provision of credit, however, is uneven across regions. The bank credit ratio is low in both oil-producing regions (with exception of Aktobe) and the agricultural oblasts. Bank credit is relatively high in the non-oil industrial oblasts and especially in the municipal districts (Astana and Almaty).”¹³²

The critiques of the transition economies which are generally applied, i.e. the absence of a “culture of entrepreneurship” etc. do not seem to be valid in this case. A survey conducted in 2011 by the Kazakh prime minister’s office showed that 89 percent of respondents would like to start their own business (for comparative purposes the figure found in Belarus in a 2012 Carnegie Endowment survey was 46.9%).¹³³ The same poll also set out the reasons for the seeming reluctance of individuals to do so, with

¹³⁰*Ibid*, p. 17.

¹³¹*Ibid*, p. 16.

¹³² Bruce Bolnick et al. 2007. *Kazakhstan Regional Disparities: Economic Performance by Oblast*. Washington DC: US Agency for International Development.

¹³³ The figure as to entrepreneurship is cited in a report prepared by the UNDP for the Kazakh Supreme Court. Supreme Court of Kazakhstan. 2014. “Уровень доверия – как основной критерий оценки эффективности работы судов.” and Carnegie Endowment. 2012. *20 Years of Belarus’s Independence: Current Challenges and Future Development*. Washington DC: Carnegie Endowment for International Peace.

nearly 60% citing lack of access to capital. This fact is borne out by the lending practices of the country's major banks (see figure 3.5) which have severely limited lending to SMEs. The composition of the SME sector is also noteworthy (see figure 3.6). Kazakh SMEs are heavily concentrated in the retail and agricultural industries, with minimal activity in light or heavy manufacturing and an almost non-existent share of the country's export base. Even in areas such as construction, normally a core location for SMEs – the numbers in Kazakhstan are disproportionately low.

While the SME sector remains small, it is not simply the lack of development of these types of firms that has diminished legal demand, it is that those firms that do exist avoid the economic courts. Consistent rulings in favor of state-linked firms have contributed to a perception of corruption and an overall distrust of the economic courts resulting in the utilization of private arbitration tribunals. The maintenance of close ties to the state by the Big Ten firms – through a revolving door linking government agencies and the boardroom as well as state investment/ownership – is, with a small amount of variation, universal among the Big Ten firms.

Figure 3.5: Lending to SMEs¹³⁴

¹³⁴ See footnote 135 for source reference.

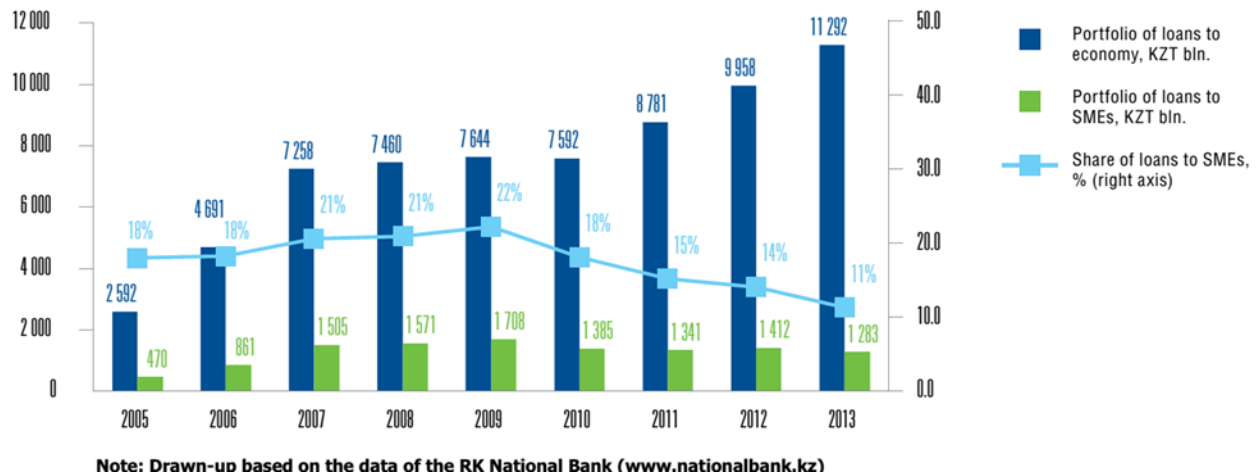
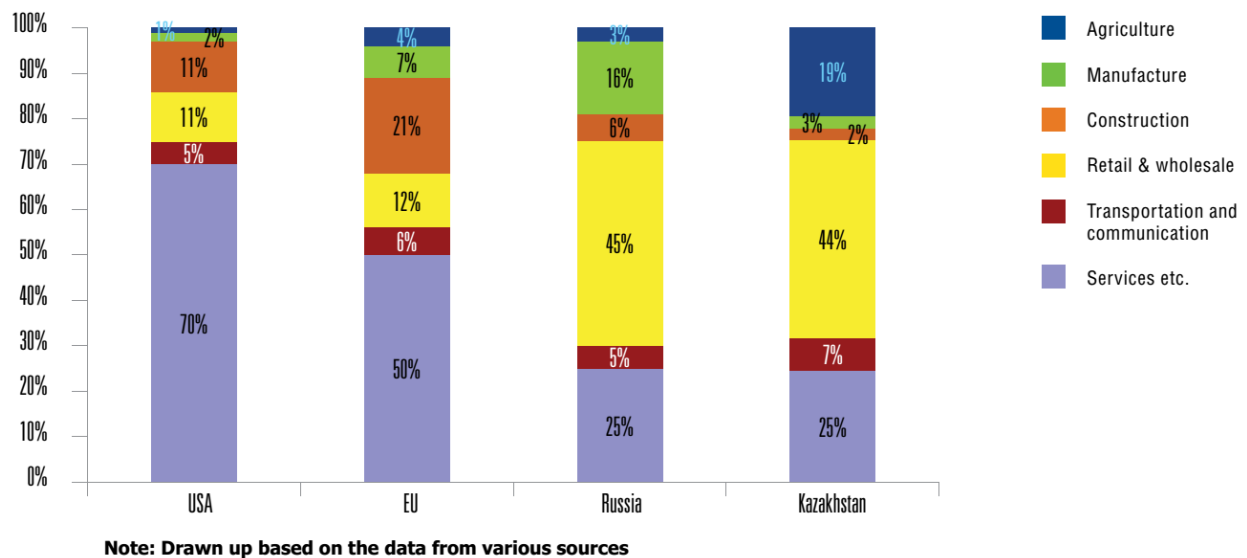


Figure 3.6: SMEs in Kazakhstan by Industry¹³⁵



State-Business Ties and Elites in Kazakhstan

This dissertation contends that an inherent aspect of the market power variable is the presence of close ties between the state and firms with high levels of market power.

¹³⁵ See footnote 135 for source reference.

It is through those ties that firms are able to exert influence on the court system. The question of state ties is rather complex owing to the controversy in the literature with regard to elite politics in the relatively opaque Kazakh state. The resource sector has been central to the interests of the Kazakh state since the mid-1990s, as Domjan and Stone have noted.¹³⁶ President Nazarbayev's own *Kazakhstan 2030* economic plan emphasizes this fact repeatedly, setting out a strategy of using funds generated by the resource sector in order to support improvement of standards of living, economic competitiveness, and infrastructure.¹³⁷ To grasp the nature of firm-state ties in Kazakhstan, it is imperative to understand the nature of the Kazakh state and its ruling elite. As Kazakhstan, with the exception of a brief period of pluralism in the early 1990s, has been classified as an authoritarian state, the locus of decision making is significantly less clear than in other countries. Absent a workable outline of elite politics and some degree of clarity as to business-state relations within the confines of a generally opaque system of governance, the ability to employ "state ties" as a component of the independent variable is seriously compromised.¹³⁸

¹³⁶ Paul Domjan and Matt Stone. 2010. "A Comparative Study of Resource Nationalism in Russia and Kazakhstan, 2004–2008," in *Europe-Asia Studies*, vol. 62:1, pp. 35–62.

¹³⁷ Richard Pomfret. 2013. "Kazakhstan's 2030 Strategy: Goals, Instruments and Performance," paper presented at the American Economic Association annual conference on 4 January 2014 in an Association for Comparative Economic Studies panel on Kazakhstan's Economic Strategy: Halfway to 2030.

¹³⁸ Schatz 2004, p. 111. Collins has contended that models of elite change in European transition economies are invalid in Kazakhstan and has argued that a framework based on clan (zhuz) linkages better captures the realities in Astana and Almaty wherein following independence the nation reverted to pre-Soviet, traditional social structures. Schatz, while rejecting the historical reversion aspect of this argument, concurs with the clan based conclusion, but considers it a uniquely post-Soviet, rather than Tsarist era creation. Murphy has highlighted the empirical issues with the clan based approach, namely the fact that clan affiliation was never officially recorded, requiring the use of a geographic proxy and ultimately basing clan membership on the regional origin of the individual in question.

In light of the evidentiary challenges with the clan approach, Murphy has contended that Kazakhstan is best understood by following the same approach taken by those studying the Russian transition. Developing a database utilizing *KtoEst' Kto v Kazakhstane*, Murphy finds the existence of a consistent, central elite which has held power since the end of the Soviet era and has managed to undermine the creation of an independent acquisition class and ultimately a vibrant SME sector. The ultimate outcome of this situation has been that while the economy of Kazakhstan is (somewhat) privately owned, those who do own it are in fact the same people who run the state with regular movement between the two sectors.¹³⁹ The case of Kabilidolla Sarekenov illustrates this reality quite well: a graduate of Karaganda Polytechnic University and the Higher Party School in Almaty, he went on to serve as deputy secretary of the Communist party organization at the Karaganda Metallurgical Combine, where Nursultan Nazarbayev served as secretary. He eventually moved on to a series of party posts before taking on a management role at the post-independence conglomerate Kramds from which he was appointed to the chairmanship of the Astana Tax Committee before moving on to lead the Committee on Strategic Mineral Reserves.

This creates severe problems for the classification of individuals in urban areas in light of clan diversity and inter-clan marriage in those locations. A valid clan based system would certainly be intriguing in light of the geographic dispersion of the Kazakh economy and have significant implications as to the question of how firm-state ties operate. However, the data presented by Schatz is insufficient to accept that framework and permits us to safely disregard this approach. He himself admits as much when he states, apropos of the seeming lack of data as to the importance of clan affiliation, that the clan "retain(s) its position by restraining itself from systematically privileging its own kind" and ends by contending that only "thick ethnographical enquiry" can only make this reality observable.

¹³⁹ Murphy 2006, p. 536.

The history of KazMunayGaz (KMG) is also of use here.¹⁴⁰ For such a significant player in the global energy market, KMG is a relatively young firm. Established in 2004 as the successor to KazakhOil, the firm was created with the intention of gaining greater domestic control over the hydrocarbon sector, increasing the amount of reserves through exploration, the development of new lines of transport, increasing the share of domestically produced goods, and supporting the broader development of the oil and gas sector. Today it is the third largest oil producer in the country but with a minority stake in almost all other oil and gas projects in the country and a controlling stake in most projects which have been initiated since 2000. Employing 34,000 people, the firm directly controls a network of 25 subsidiaries.

KMG is managed by a five person board of directors, led by Timur Kulibayev who, as noted above, also serves as vice chair of country's SWF and is the son-in-law of Nazarbayev. Day to day management is under the control of UzakbaiKarabalin who has worked in first the Soviet and then Kazakh oil industry since 1973 and served as deputy minister of energy and mineral resources until 2003. His deputy, ZhaksybekKulekeyev, formerly served as minister for the economy and minister of education, joining the firm in 2006. One additional figure of note, DaniyarAbulgazin, managing director for finance, has a unique background in the Soviet and Kazakh

¹⁴⁰ Data as regards the development and history of KazMunayGaz come from Martha Brill Olcott. 2007. "KazMunaiGaz: Kazakhstan's National Oil and Gas Company," policy report for the James Baker Institute for Public Policy, Rice University as well as interviews conducted in Almaty and Astana in March – June 2010.

security services. A member of the last graduating class of the Felix Derzhinskii Higher School of the KGB, he subsequently went on to rise to the position of vice minister of finance, serving in that role until joining KMG's predecessor, KazakhOil, in 2002.

This understanding of the state-business relationship stands in contrast to other models of state-business ties. Kjarnet, Satpaev, and Torjesen argue that there exist simultaneously three different approaches: (i) firms without patrons but which essentially rely on lobbying through contacts in various state agencies; (ii) firms which are under the protection ("roof") of a high level state official who is able to utilize his own network to provide protection and to take a share of the profits; and (iii) direct ownership by state officials.¹⁴¹ While the second of these is certainly present among those firms which constitutes the SME sector, the question of ownership is most germane among the ten larger firms focused on in this project. It is useful here to highlight the point made by Clarke, Murrell, and Whiting as to the experience of China and the possibility that a gradual process of the state exiting the market may be essential to the development of the rule of law.¹⁴² In the case of Kazakhstan, the state has been increasing its role in the market over the past decade, steadily accounting for an increasing share of GDP through its ownership/investment in various firms. Thus, an additional factor must be taken into consideration, i.e. that the state continues to maintain full or partial ownership of 574 firms nationwide through the country's

¹⁴¹Kjarnet, Satpaev, and Torjesen 2008, p.97.

¹⁴² Clarke, Murrell, and Whiting 2006.

sovereign wealth fund (SWF) Samruk-Kazyna, including such heavyweights as KazMunayGaz (KMG) and KazAtomProm.

Established in 2008 through the merger of the Kazyna Sustainable Development Fund and the Samruk State Holding Company, Samruk-Kazyna is formally charged with the management of state assets and the representation of the state in major national firms. The fund's total assets were estimated to equal approximately 55% of GDP in 2014.¹⁴³ Ostensibly formed to support the diversification of the Kazakh economy, it appears to have done just the opposite. The leadership of this entity is particularly telling. In 2011, Timur Kulibayev, son-in-law of NursultanNazarbayev, was appointed as vice-chairman and CEO of the fund, at the same time as serving as chairman of KMG, the national railway Kazakhstan TemirZholy, and the primary national power producer Samruk-Energo.

Samruk-Kazyna's board of directors is chaired by the prime minister and its membership includes the president's chief of staff, three independent directors, and the ministers of finance, industry and trade, economic development, and oil and gas.¹⁴⁴ Under the provisions of a 2009 law signed by Nazarbayev, the SWF maintains certain special rights, e.g. the ability to conclude large transactions among its constituent firms without public notification; priority in the purchase of bankrupt assets and strategic

¹⁴³ Natural Resource Governance Institute. 2014.

<http://www.resourcegovernance.org/countries/eurasia/kazakhstan/overview>

¹⁴⁴ Martha Brill Olcott. 2011. "Kazakhstan's Oil and Gas Development: Views from Russia and Kazakhstan," in Adrian Dellecker and Thomas Gomart (eds) *Russian Energy Security and Foreign Policy*. London: Routledge.

facilities; and exemption from government procurement rules. Moreover, other types of state property can legally be transferred to Samruk-Kazyna. In addition to Samruk-Kazyna, the state operates five other holding companies. The activities and management of each are as follows:

1. KazAgro which manages the state's agricultural holdings, including the National Food Contract Corporation (government wheat purchasing agent), KazAgroFinance (equipment subsidy provider), Agrarian Credit Corporation, Corporation on Livestock Development, and the Fund for Financial Assistance to Agriculture. The board is chaired by a deputy prime minister and directors include the ministers of finance, agriculture, and economic development along with three independent directors.
2. Parasat is focused on the development of the country's nascent high tech sector and manages several scientific institutions and funds. Its board is also chaired by a deputy prime minister and includes the minister of education, a vice-minister of economic development, and the chairs of the state property and science committees.
3. Zerde was created to support the development of the communications sector and is directly subordinate to the Ministry of Communications and the prime minister's office.
4. The National Medical Holding Corporation maintains control over the capital city's newly built medical facilities and has some purview over the recently formed national

flag ship institution of higher education, Nazarabayev University. The board is also chaired by a deputy prime minister.

5. Kaspikor is the most recent state creation, established in 2011 to support the development of vocational education in various fields.

The variable of state ties is understood in this case as a binary variable with a positive score on either of two potential components: (i) a partial stake or full ownership by the state through Samruk-Kazyna or one of the other state holding companies set out above and/or (ii) major shareholders/firm executives who have held/continue to hold positions in the government. As noted earlier, the clan based model is rejected in favor of an approach which argues for the continued maintenance of power by the pre-independence Soviet elite. As set out in figure 3.7, all firms receive a positive score as regards management links to the state with at least one board member and one senior executive (CEO or president) having served in a state position.¹⁴⁵ All but two of these firms have some form of either state ownership or investments through one of the six state investment funds.

¹⁴⁵This data is available via “Who’s Who in Kazakhstan” as well as through the various annual reports of the respective firms.

Figure 3.7: State Ties and Kazakhstan’s “Big Ten”

Firm	Industry	State Ownership/Stake	Management
KazMunayGaz (KMG)	Oil and Gas	Owned	Yes
KazAtomProm	Uranium	Owned	Yes
Tau-Ken Samruk	Minerals (diverse)	Owned	Yes
ENRC	Oil and Gas	No	Yes
Mangistaumunaygaz	Oil and Gas	Stake	Yes
KAZ Minerals	Copper	Stake	Yes
Kazzinc	Zinc/Lead/Copper	Stake	Yes
Alyuminiy Kazakhstan	Aluminum	Stake	Yes
KazKhrom	Ferrous alloys	No	Yes
Ust- KamenogorskiiTitano- MagnievnyyKombinat	Titanium and Magnesium	Stake	Yes

It is argued here that through their dominant position in the economy and these linkages, the Big Ten firms have undermined trust in the courts and ultimately, weakened legal demand. Before examining the role and experiences of these firms in

the economic courts, it is first necessary to set out the basic structure of the Kazakh judicial system.

The Kazakh Judicial System: A Patchwork of Courts

Owing to challenges in translation and an unfortunate lack of diversity in the English language as compared to the generous cornucopia that is Russian, for the sake of clarity, hereafter the following terminology is utilized: (i) State Arbitration refers to the Soviet era system of commercial dispute resolution (GosArbitrazh); (ii) Economic courts refers to the formal, set of courts in Kazakhstan (i.e., the Kazakh judiciary) which only handle property and contractual disputes; (iii) Arbitration or arbitration tribunal refers to non-state organizations which provide private dispute resolution services (e.g., the Kazakhstan Chamber of Commerce's arbitration panel).

The legal system of Kazakhstan is grounded in the legal traditions of the Soviet Union and pre-revolutionary, Tsarist era law. Solomon and Fogelsong summarized the realities of the Soviet system which was in place in Kazakhstan until the ratification of a new constitution in 1993:

“As an authoritarian state with a largely state-owned and administered economy, the USSR treated law as simply of one of a number of instruments of rule, and not even as the dominant one. Both political decisions and administrative regulations took precedence over law and even the application of regulations took an ad hoc form and was strongly influenced by personal relationships.”¹⁴⁶

¹⁴⁶ Peter Solomon and Todd Fogelsong. 2002. “Courts and Transition in Russia: The Challenge of Judicial Reform,” in *Political Science Quarterly*, vol. 117:1.

The Kazakh SSR, as a constituent republic of the Soviet Union, was incorporated into the system of state arbitration established under the purview of the State Planning Committee in 1931. Following the disintegration of the USSR, the Russian Federation converted GosAbitrazh into a national system of economic courts on January 1, 1992. As Davis has noted, "Kazakhstan's first Constitution, adopted in 1993, merits little mention in terms of judicial reform, save for the fact that it failed to provide for separation of branches of government."¹⁴⁷ Kazakhstan maintained the state arbitration system until the adoption of a new constitution in 1995 at which time a new system of state courts for economic disputes was created.

Kazakhstan currently maintains three levels of courts. At the pinnacle is the Supreme Court, comprising 48 members, which is divided into criminal, civil, and supervisory systems. The high court hears cases in panels of nine or three judges and meets *en banc* in order to issue guiding opinions to the lower courts. At the secondary level are the oblast (provincial) courts, also divided into three sections and including 572 judges dispersed across the 14 oblasts which comprise the republic. These cases hear appeals from the lower rayon (district) courts and act as a court of first instance for more serious matters. Similar to the Russian Federation's arbitration courts, Kazakhstan maintains a separate set of 16 economic courts. These courts hear property and non-property disputes between legal entities and/or individual entrepreneurs. It is these

¹⁴⁷ Kyle W. Davis. 2002. "Purging the System: Recent Judicial Reforms in Kazakhstan," in *UC Davis Journal of International Law and Policy*, vol. 8.

courts which are the focus of this dissertation and where measures of legal demand are taken.

Upon their establishment in the Kazakh judiciary, these courts were initially incorporated into the broader civil court system. The inherent problems stemming from the combination of arbitration courts and courts of general jurisdiction led to their establishment as separate courts two years later. The vast majority of commercial disputes are tried in the economic courts which have jurisdiction to review all commercial disputes, regardless of size, provided both parties to the dispute are domestic legal entities or entrepreneurs. However, not all questions as regards jurisdiction have been settled. The economic courts only hear cases arising from disputes among domestic economic actors – in cases where one party is a foreign firm, the oblast courts maintain jurisdiction (in practice, these firms almost exclusively utilize private arbitration tribunals either inside or outside of Kazakhstan). This has been problematic in that the oblast courts do not maintain chambers with particular expertise as regards business disputes and have gained very little experience in light of the near total lack of demand for their rather dubious services. The unreliable state court system is marked by severe weaknesses not just in impartiality but also in efficiency and speed of adjudication. A 2013 World Bank study showed the average contract dispute in the economic courts taking 370 days to bring to completion against a global best practices

benchmark of 150.¹⁴⁸ The number of procedures which firms seeking relief from the courts were required to carry out clocked in at 36, nearly double the international standard of 20. Foreign firms engaged in business in Kazakhstan generally utilize international and local arbitration facilities rather than the oblast level courts.

The Economic Courts in Practice: Undermining Legal Demand

The state of the Kazakh judiciary has been the source of a great deal of survey work in recent years; however, the conclusions these surveys have produced have been wildly diverse. A 2014 UNDP survey of users of civil courts, much touted by the Kazakh Supreme Court, showed a remarkable 89% of users of civil courts reported an overall positive experience.¹⁴⁹ This impressive figure contradicts a 2012 Supreme Court survey which showed 68% of court users have “no trust” in the country’s judges.¹⁵⁰ The 2014 World Bank Rule of Law Index places Kazakhstan in the relatively positive position of 65th globally, ranking it above Russia and most other post-Soviet states.¹⁵¹ In contrast, Transparency International’s Corruption Perceptions Index places Kazakhstan at 140, near the bottom internationally.¹⁵² The World Economic Forum’s surveys have consistently given exceedingly low scores as regards corruption in the judiciary and the

¹⁴⁸ World Bank. 2014. World Governance Indicators. <http://databank.worldbank.org/data/databases/rule-of-law>

¹⁴⁹ Supreme Court of Kazakhstan. 2014. “Уровень доверия – как основной критерий оценки эффективности работы судов.” <http://sud.gov.kz/rus/content/informaciya-o-rezultatah-sociologicheskikh-oprosov-i-ocenki-deyatelnosti-sudov>

¹⁵⁰ Supreme Court of Kazakhstan. 2012. *Результаты независимого социологического исследования в судебной системе Республики Казахстан*. Astana: Supreme Court of Kazakhstan.

¹⁵¹ World Bank. 2014. World Governance Indicators. <http://databank.worldbank.org/data/databases/rule-of-law>

¹⁵² Transparency International. 2014. Corruption Perceptions Index. <https://www.transparency.org/cpi2014/results>

protection of property rights.¹⁵³ Rather than answering the question, the extant body of surveys brings observers of Kazakhstan no closer to grasping the realities on the ground as to the current state of the economic courts. An alternative approach is required, i.e. an examination of how the courts work in practice and how SMEs engage in dispute resolution. Very little research has been done in this vein.

Martha Brill Olcott, utilizing a small sampling of cases in which large, resource firms were the respondent, found that there was no consistent pattern of bias in favor of those entities.¹⁵⁴ Designed to explore the broader relationship of resource firms to the state, Olcott's survey sampled rulings across a variety of courts. The sample size was exceedingly small (four or fewer rulings per firm) and included decisions from tax and administrative law courts. Civil judgments related to disputes between firms were less than 40% of her sample size. While Olcott is able to show that the relationship between large firms and the state can be adversarial as regards tax payments and various aspects of administrative law, she is unable to show that in dispute between firms there is no bias in favor of large firms with state ties. Moreover, she does not include data as regards the SME sector.

¹⁵³ World Economic Forum. 2014. *The Global Competitiveness Report*. <http://www.weforum.org/reports/global-competitiveness-report-2014-2015>

¹⁵⁴ Martha Brill Olcott. 2007. "KazMunaiGaz: Kazakhstan's National Oil and Gas Company," policy report for the James Baker Institute for Public Policy, Rice University.

Utilizing the same database, provided by the Kazakh Supreme Court, I sampled cases in the economic courts for each of the “Big Ten” firms.¹⁵⁵ A simple random sampling approach was adopted to ensure that all cases in the population had an equal chance of being selected. Each case selected was a contractual dispute between one of these firms and a firm which can be classified as a SME (i.e., having under 250 employees).

This process entailed multiple steps. First, all contractual dispute cases in 2013 (the most recent year for which all cases were available) involving one of the Big Ten firms were pulled from the database. This pool of cases was then narrowed by eliminating all cases where the other party was not a SME. For each large firm, every case in which that firm was a party was numbered consecutively (this was done ten times, once for each firm). Selection of cases within the pool of each firm was done through a random number generator with ten cases selected per firm pool.

Of these 100 rulings, 73 were in favor of the larger firm. In the case of KazMunayGaz, 9 out of 10 judgments favored the state owned oil and gas giant. The numbers very much contradict the contention of Olcott that the country’s largest firms, despite their state ties, do not have any inherent advantage in the courts. The numbers become even more telling when disaggregated by region and analyzed in light of the market power of the country’s Big Ten firms. Owing to data accessibility issues, I was

¹⁵⁵ Please see appendix one for a more thorough summary of the methodology used here and a fuller summary of the data.

unable to determine those provinces where the Big Ten firms and their hundreds of subsidiaries maintain the highest amount of market power. As a proxy for this, I used the percentage of GDP contributed by the resource sector. Akmola is the region of Kazakhstan where resources contribute the greatest overall share of GDP – approximately 88% of the oblast’s GDP can be credited to the resource sector. Taking a sample (having employed the methodology set out above) of ten contractual disputes in the provincial economic court between Big Ten firms/subsidiaries and SMEs in 2013– in all but one case, the ruling was against the smaller firm. The one remaining case was resolved via mediation before adjudication, no information was available as to the outcome. Even allowing for differences in the quality of representation, this gap is certainly significant. The case of Akmola is particularly interesting when looked at in terms of total legal demand.

Legal demand here is measured as the total number of cases filed per year. In an economy such as Kazakhstan which, as noted above, has had an average annual GDP growth rate of close to 8% since 2000, the expectation would be that there would be a concomitant uptick in the utilization of courts. However, this has not been the case. According to figures from the Kazakh Supreme Court, from 2008 (the first year for

which a full set of numbers are available) to 2014 the number of cases filed in the economic courts per annum has held steady – fluctuating between 50,000 and 55,000.¹⁵⁶

It is essential to note that this stagnation has taken place despite massive investment in the supply of law, e.g. new technology, a new bar association, new infrastructure, and an increase in the number of judges in the economic courts from just 124 in 2004 to approximately 250 in 2010.¹⁵⁷ The supply is there, but demand remains stagnant. This stands in contrast to the experience of Russia which has seen minimal investment in the supply of law, yet year on year has seen regular and consistent increases in the demand for law, i.e. the number of cases filed per year (see chapter 3).

To further explore this issue, I looked at the demand for law across the 16 provinces of Kazakhstan. Again, to measure the market power of the Big Ten firms I utilized the percentage of GDP contributed by the resource sector (in that each of these firms are resource based and the sector itself is overwhelmingly dominated by these ten large firms and their constituent firms). I then looked at the total number of contractual disputes submitted to those courts in order to rank all 16 provinces by legal demand, from highest to lowest (see figure 3.8). Again, as noted in chapter one, the methodology here utilizes the total number of cases for the year 2014. The total number of cases per

¹⁵⁶Supreme Court of Kazakhstan. 2014. “Уровень доверия – как основной критерий оценки эффективности работы судов.”

¹⁵⁷ The figure for 2004 comes from ABA/CEELI’s report *Judicial Reform Index for Kazakhstan*. 2004. Washington DC: American Bar Association. The Kazakh Supreme Court, despite constitutional responsibility for the maintenance and reporting of judicial statistics, does not

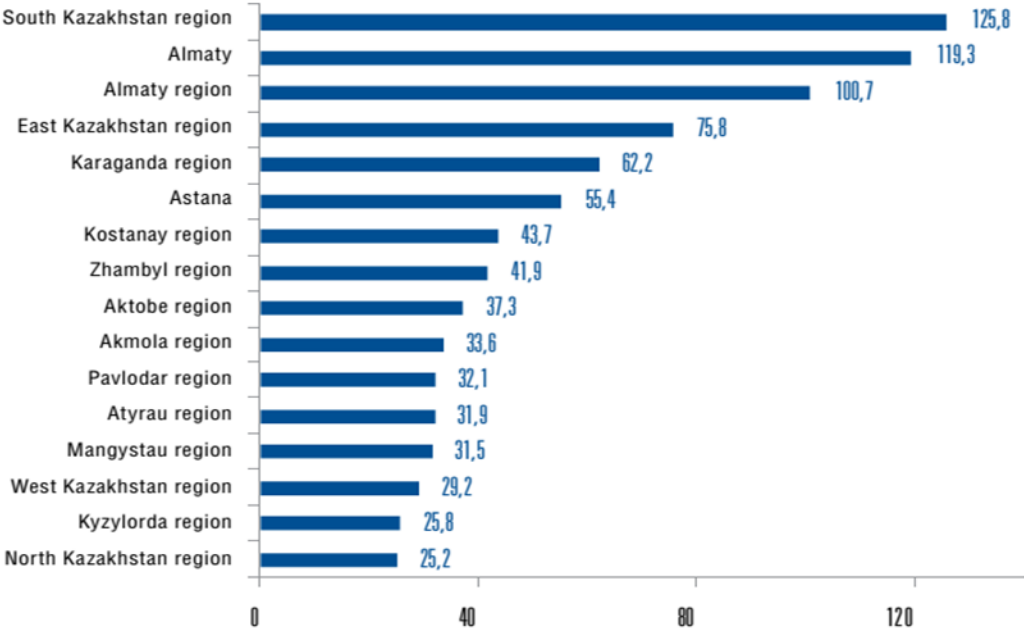
province is then divided by that province's share of national GDP in order to resolve the problem of the differing sizes of the economies of the various provinces.

Figure 3.8: GDP, Resource Market Power and Utilization of Courts

Province	Share of GDP	Resource Market Power	Legal Demand Rank/Score
Almaty	18.7%	12%	1 (665.83)
Zhambyl	2.1%	4%	2 (563.80)
Astana	8.1%	26%	3 (557.04)
Baikonur	5.1%	31%	4 (530)
North Kazakhstan	2.4%	40%	5 (501.67)
Kyzlorda	3.8%	31%	6 (493.95)
South Kazakhstan	5.4%	22%	7(477.41)
Karaganda	8.9%	55%	8 (433.03)
Pavlodar	5.1%	41%	9(417.06)
West Kazakhstan	4.8%	71%	10 (385.20)
Aktobe	5.0%	74%	11 (312)
Akmola	3.1%	88%	12 (306.77)
Kostanay	4.3%	65%	13 (281.86)
East Kazakhstan	5.8%	74%	14 (280)

Atyrau	11.6%	78%	15 (260.95)
Mangystau	6.5%	84%	16 (224)

Figure 3.9: SMEs in Kazakhstan by Oblast (in thousands)



Note: Drawn up based on the data of the RK Statistics Agency (www.stat.gov.kz).

At the bottom are provinces such as Akmola and Mangystau, areas where the market power of the country’s largest firms is greatest. At the top, in addition to the country’s economic center of Almaty at number one, is tiny Zhambyl province – a border region with minimal resources where the economy is dominated by cross-border trade and (see figure 3.9) the number of SMEs per capita is among the highest in the country. However, it is important to note that the tail ends of this spectrum should be looked at with a degree of caution. Atyrau, for example, produces 11.6% of the country’s

GDP while maintaining only 3% of the country's overall population¹⁵⁸ owing to its massive oil deposits. Thus, its contract law cases as weighted by GDP rank may be of less value here. However, an additional aspect of contract dispute in Kazakhstan is likely salient here as regards the remarkably low number of cases in those provinces where the resource industry is dominant: the phenomenon of "in-house adjudication." This unique attribute of both the Kazakh and Russian legal systems has been growing in both countries over the course of the last decade. While regularly reported on in the main legal newspapers and journals within both countries, it has yet to receive significant attention in overseas academic research. The process is relatively straightforward: firms that are subsidiaries of several of the Big Ten firms (most notably KazMunayGaz, the country's largest firm) write contracts with clauses that stipulate where, in the event of dispute, the case will be adjudicated. This is rather standard in contracts between foreign and domestic firms, with clauses regularly stating that the International Chamber of Commerce in London or some other such private arbitration tribunal would be the site for an aggrieved party to file a claim.¹⁵⁹ In this case it is the venue that is of interest. Rather than agreeing to a foreign or domestic private arbitration tribunal, the two parties to the contract agree to resolve the dispute via an "in-house" arbitrator who works directly for the Big Ten firm in question. Thus, as

¹⁵⁸ Population figures of Kazakhstan employed here are from the National Analytical Center of Kazakhstan, accessed November 18· 2015. <http://www.nac.gov.kz/en/news/analytics/252/>

¹⁵⁹ E.K. Dosmukhamedov. 2002. *Foreign Direct Investment in Kazakhstan: Politico-Legal Aspects of Post-Communist Transitions*. London: Palgrave.

explained during interviews in Astana in 2011, a partial subsidiary firm or a firm in which KazMunayGaz has a stake that is contracting with KazMunayGaz will agree to the judgment of KazMundayGaz's own arbitrator.¹⁶⁰ The implications of this system are particularly interesting both as regards the development of Kazakh (and Russian) law since the collapse of the USSR but also with regard to the question of legal demand. As to the former, this sort of approach – the presence of an arbitrator with a “stake” in the outcome is distinctly parallel to the approach taken during the Soviet era in which in the event of a conflict between two state firms, both ultimately under the control of GosPlan (the main state planning entity that would assign annual production quotas), resolution of the dispute would come from an arbitrator provided by GosArbitrazh (as noted above, the main entity responsible for the resolution of economic disputes and also directly under the authority of GosPlan). The seeming re-configuration and re-deployment of Soviet era adjudication procedures in a 21st century economy is a remarkable testament to the durability of institutional forms across different regime types.¹⁶¹

In addition to the question of institutional reproduction noted above, it is also necessary to take account of the fact that these clauses, according to senior attorneys working in Astana, are a regular aspect of contracting among the largest firms in

¹⁶⁰ Interviews with the author at KazMunayGaz, Astana, Kazakhstan – May 2011.

¹⁶¹ I plan to continue researching these “in house” tribunals during a second round of field work in Kazakhstan to be completed in summer 2015.

contemporary Kazakhstan.¹⁶² Thus, to return to the question of such remarkably low figures as regards the number of contract cases in the economic courts in regions that are dominated by the Big Ten firms – it is likely that a significant number of cases (getting exact numbers has proven to be impossible) that normally would go to the economic courts are being diverted to these “in house” adjudicators, depicting an additional path whereby legal demand is undermined and legal reform continues to succeed.

To return to the central point of this chapter: even if the tail ends of the spectrum are discounted, the correlation across the entire set of provinces remains remarkably strong. This correlation supports the hypotheses proposed in this dissertation, i.e., in locations where large firms with political ties are dominant, legal demand will be low while in those areas where there is a high number of SMEs, legal demand will be stronger. However, if firms are not utilizing the courts, how are contractual disputes being resolved among SMEs? Is this simply a case of an absence of contractual disputes rather than the abandonment of the economic courts? The answer to this question is two-fold.

First, it is necessary to question the assumption that firms are utilizing contract in the first place. Rather, following the experience of Russia in the 1990s, it appears that a significant portion of the Kazakh economy operates in the so-called “shadow

¹⁶² Interviews with the author in Astana, Kazakhstan – May 2011.

economy,” engaging in business completely outside of the purview of the state. This contention is supported by the most recent estimates as to the size of the shadow economy in Kazakhstan. DossymSatpayev of the Risk Assessments Institute in Almaty along with other experts has estimated that 35% of the Kazakh economy operates in this “grey zone,” without registration as legal commercial entities and absent the legal standing required to utilize the economic court system. In other words, firms are relying on traditional “krisha” approaches, i.e. enforcement through extra-judicial means. However, owing to the nature of this economy, firm data is hard to come by beyond the estimates from the Risk Assessments Institute and various multilateral aid agencies. The second part of the answer comes from the vast expansion of private arbitration tribunals since 2004.

Second Best Options: Private Arbitration

In the decades following independence, private arbitration became an increasingly popular alternative to the nascent system of economic courts. This was also the case in the Russian Federation (see chapter three) throughout the 1990s. Two pieces of legislation were implemented in the early 1990s to regulate the emerging set of private arbitration: the Model Regulation on Arbitration Courts was approved by the Cabinet of Ministers in May 1993 together with the law on Model Regulation on the Resolution of Economic Disputes in which article 134 provided for the compulsory

execution of the awards of private arbitration tribunals by the state economic courts.¹⁶³ Tribunals such as the Arbitration Commission of the Kazakhstan Chamber of Commerce were established and have been well regarded by the business community, maintaining a reputation for honesty and competence, the charging of reasonable fees, and the prompt and efficient consideration of cases. The Civil Procedural Code which was adopted in 1999¹⁶⁴, however, eliminated the execution clause of the 1993 legislation, essentially rendering private arbitration irrelevant. This ultimately resulted in the refusal by state courts to issue orders for the enforcement of awards depriving the awards of these courts of legal effect. Valery Zhakenov, one of the earliest practitioners of private arbitration in Kazakhstan has noted: "On this basis, the Office of the General Prosecutor with the support of the Ministry of Justice undertook attacks on the arbitration tribunals.

By 2004, legislation governing the conduct of arbitration was adopted resulting in state courts reconsidering their approach to arbitration. The legislation was modified several times and in many respects to ensure the enforcement of awards issued by arbitral tribunals. The main legislation governing the conduct of private arbitration in Kazakhstan was adopted in December 2004. The applicable legislation includes: (i) the "International Arbitration" law, which applies to arbitration proceedings where at least

¹⁶³ Model Regulation on Arbitration Courts and Model Regulation of Economic Disputes, approved by regulation 4 of the Kazakhstan Cabinet of Ministers, May 4, 1993.

¹⁶⁴ Law of the Republic of Kazakhstan dated June 13, 1999, No.412 "On Introduction of the Civil Procedure Code of the Republic of Kazakhstan."

one party is a foreign national; (ii) the "Domestic Arbitration" law which applies to arbitration proceedings where both parties to the proceeding are nationals of Kazakhstan; and (iii) the civil procedure code which also contains a number of rules applicable to the conduct of arbitration as well as recognition and enforcement of foreign arbitral awards.¹⁶⁵ Under these regulations, certain cases are not permitted to be brought before private arbitration tribunals, e.g. disputes related to the interests of the state, bankruptcy, state enterprises, and most notably any dispute arising out of contracts for services and production involving firms holding natural monopolies and a dominant market position. While ostensibly this law serves to protect small firms from arbitration tribunals which could be influenced by firms with significant market power and state enterprises (in reality these categories are identical), the implications have in fact been the opposite. Firms doing business with state enterprises are practically barred from utilizing the country's well developed network of private arbitration tribunals and are required to go through the state court system when contesting contracts with state firms, i.e., they are forced into courts where politically connected firms have their strongest ties (as noted earlier, surveys indicate that private arbitration in Kazakhstan is widely perceived to be fair and honest).

¹⁶⁵ Law of the Republic of Kazakhstan on International Commercial Arbitration. Astana, Akorda. December 28, 2004 No. 23-III ZRK. Law of the Republic of Kazakhstan on *TreteiskiiSudi*. Astana, Akorda. December 28, 2004 No 22-III ZRK.

Currently, legislation governing conduct of arbitration in Kazakhstan is similar to the UNCITRAL model law, and the civil code has been revised several times in order to improve the flow of cases to arbitration and improve the relationship between state courts and private arbitration tribunals. As noted earlier, arbitral institutions operating in Kazakhstan maintain quite a high degree of trust (Judiciary Gazette 2014). In recent years, disputes by domestic actors in which no foreign party is involved which historically were referred to foreign arbitration (e.g., the London Court of International Arbitration, the International Chamber of Commerce, and the Arbitration Institute of the Stockholm Chamber of Commerce) are increasingly submitted to local tribunals. It is precisely this network of arbitration which acts as a drain on the legal demand necessary to facilitate legal reform.

No statistics are available as to the total number of cases submitted to private arbitration. However, there are alternative sources of data. The first of these is the number of cases which have been filed in the economic courts, but which have been resolved through private arbitration. This option – a judge referring a case to private arbitration with the consent of both parties – has only been available in the economic courts since 2012. According to figures from the Kazakhstan Supreme Court, in 2014 the number of contract cases resolved through referral to private arbitration was 10,613 – a

ten-fold increase from the first year this was permitted.¹⁶⁶ When placed in the context of the consistent 50,000 – 55,000 cases annually filed in the economic courts, this shows that while there has been an increase in the number of cases brought for adjudication the growth is being absorbed by private arbitration rather than being adjudicated by the judges of the economic courts. Kazakh firms appear to be taking advantage of the benefits of filing in courts, i.e. greater speed in the enforcement of awards and the ability to enjoin assets at the outset of a case, but subsequently utilizing outside, private arbitration to resolve the dispute. Additional data which supports this contention include year on year increases ranging from 15 to 20 percent in the number of cases handled by the Kazakhstan Arbitration Chamber and the Arbitration Chamber of the Kazakhstan Chamber of Commerce since 2008.

Conclusion

Despite Kazakhstan's massive economic growth and significant investment in legal supply over the course of the past decade, the number of contractual cases heard by the courts has remained stagnant. Once those numbers are disaggregated, it also becomes apparent that all courts are not perceived equally in Kazakhstan. In those regions with relatively low market power on the part of the Big Ten firms, utilization of the economic courts (legal demand) has been substantially higher than in those regions where large, politically tied firms dominate the economy. At the same time, since the

¹⁶⁶ Supreme Court of Kazakhstan. 2014. *Справка о судебной практике по применению обстоятельств непреодолимой силы при рассмотрении экономических споров*. Astana: Supreme Court of Kazakhstan.

establishment of enforcement mechanisms for the decisions of private arbitration tribunals, these institutions have seen consistent increases in utilization. While the economy is growing, a phenomenon which should have positive spillover effects as regards legal demand, that spillover appears to be increasingly directed towards the country's private arbitration tribunals rather than the economic courts. This raises serious questions as to the future of legal reform in Kazakhstan, specifically as to whether efforts at legal supply should be continued. Rather, greater attention should be paid to the growing network of private arbitration panels – in that SMEs have increasingly turned to these alternative institutions it is necessary to consider under what circumstances they would return to the state economic courts. Alternatively, if SMEs continue to rely on private arbitration, increased support will be necessary in order to expand the network of arbitration organizations across Kazakhstan. Absent significant investment in the SME sector and a concomitant increase in the market power of these firms or a relative decline in the power of the Big Ten resource conglomerates, private dispute resolution appears to be a growing component of the legal landscape in Kazakhstan for the foreseeable future. This stands in direct contrast to the experience of Russia, which has seen year on year increases in the use of its economic courts and the relative decline of arbitration. In chapter three, the Russian case is explored in the context of the development of its SME sector and the differing contours of the FDI regulations implemented during the Yeltsin and Putin eras.

Chapter Four

Russia: From Soviet State Arbitration to Arbitration Courts

Introduction

The popular understanding of Russia is that of an oil and gas behemoth with a lawless economy in which no foreign firm would dare to invest. The first of these three misconceptions, articulated in March 2014 by U.S. Senator Lindsey Graham of South Carolina, is that Russia is essentially “an oil and gas company masquerading as a state.”¹⁶⁷ It is useful to place this in comparison to the figures regarding oil and gas in Kazakhstan set out in chapter three. While identical data is not available, a 2005 IMF report estimates that crude oil, oil, and oil products account for an almost 25% of Russian GDP and 60% of export revenues.¹⁶⁸ A 2015 statement by Russian energy minister Alexander Novak quoted by the TASS news service, placed the total of Russian budgetary revenue from the hydrocarbon sector at 52% for 2015.¹⁶⁹ The Russian economy is significantly more diverse than that of Kazakhstan, Azerbaijan, Turkmenistan and other resource exporting post-Soviet state. This chapter discusses how the diversity of the Russian economy, specifically the remarkable expansion of the SME sector and the relatively low levels of market power on the part of the country’s

¹⁶⁷ Andrey Movchan. 2015. “Just an Oil Company? The True Extent of Russia’s Dependency on Oil and Gas.” Moscow: Carnegie Endowment for International Peace. <http://carnegieendowment.org/2015/09/14/just-oil-company-true-extent-of-russia-s-dependency-on-oil-and-gas/ihtg> Accessed: December 17, 2015

¹⁶⁸ Nienke Oomes and Katarina Kalcheva. 2005. “Diagnosing Dutch Disease: Does Russia Have the Symptoms?” Washington, D.C: International Monetary Fund. <https://www.imf.org/external/pubs/ft/wp/2007/wp07102.pdf> Accessed: December 17, 2015

¹⁶⁹ TASS News Service. “Share of Oil and Gas in Russian Budget Revenue to Decline by 5% in 20 Years – Minister.” <http://tass.ru/en/economy/775919> Accessed: December 17, 2015.

largest firms – particularly those in the resource sector - has impacted legal demand and supported the development of the Russian system of economic courts.

The growth in legal demand and the subsequent development of the economic courts negates the second misconception, i.e. the image of Russia as “the Wild East,” with ubiquitous images of car bombings, mafia controlled industries, and shakedowns of small business by criminal gangs together with a set of economic courts which are at best irrelevant and at worst deeply corrupt. While the first decade of transition was marked by the absence of law and order, the regular use of *krisha* and private enforcement as a means to do business, that is no longer the case today with use of the economic courts having been regularized in large parts of the Russian Federation. Kathryn Hendley and others have diligently charted these changes over the course of Russia’s transition to a market based economy. Regions that experienced the most rapid growth in the SME sector also saw the most rapid growth in legal demand. Ironically, it was in regions such as Ulyanovsk, at the center of the so-called “Red Belt” of Soviet state industry that resisted Big Bang style reforms where SME growth was the most rapid and legal demand rose the fastest.

The expansion of legal demand, I argue, has been supported by Russia’s receipt of significant amounts of foreign direct investment – standing in contrast to the third misconception of the Russian economy: FDI in Russia is primarily directed towards large, resource based firms with overseas firms being deeply suspicious of investment

in other sectors. Conversely, it has been manufacturing and light industry which have received the bulk of attention from foreign investors in the past decade; 51% of FDI and 92% of job creation between 2007 and 2014 were located in these areas. In contrast to Kazakhstan, where FDI has been limited to larger firms and the resource sector with concomitantly deleterious effects as regards legal demand, FDI in Russia has facilitated the expansion of the SME sector through various linkages providing support for the contention that different forms of FDI and different regulatory regimes governing FDI will have different outcomes as regards legal demand. While the Russian experience of the privatization of state industry was virtually identical to that observed in Kazakhstan, subsequent development has been remarkably distinct. Where Kazakhstan has seen the expansion of private arbitration facilitated by the political support of foreign investors, the vast number of alternative institutions for dispute resolution established following the disintegration of the USSR have declined in recent years as usage of the Russian courts has risen. In contrast to the vicious circle noted in Kazakhstan, Russia – despite its much greater political and social instability – has seen consistent year on year improvement in the state of the SME sector and legal demand.

This chapter builds on earlier work which has sought to end these misconceptions while building the case for the relationship between the structure of national economies and the development of legal demand, it is organized as follows: (i) a summary of the Russian transition, specifically the process of de-centralization under

Yeltsin and re-centralization under Putin and the outcomes thereof as regards the structure of the national economy;¹⁷⁰ (ii) a discussion of the role of FDI and its importance in the diversification of the Russian economy; (iii) an exploration as to the development of the SME sector and the gradual increase in the demand for law during the administrations of Vladimir Putin and Dmitri Medvedev; and (iv) an examination of the development of the Russian economic courts at the national and provincial levels since 1991 and the continued expansion in legal demand that has supported the reform and development of those courts.

Russia's Economy in Transition: De-Centralization, Re-Centralization, and State Ties

Where the experience of Kazakhstan during the first decade of transition was one of rapid privatization under the guidance of a highly centralized regime that of Russia was one of near constant de-centralization and what at times appeared to be the potential for the disintegration of the Russian Federation. This decentralization would also result in a diversity of policy programs across the country with differing impacts on the initial development of the SME sector. Upon accession to office in 2000, Vladimir Putin set as one of his primary tasks the implementation of fundamental changes in the structure of central-regional relations which would significantly impact the ultimate

¹⁷⁰ As the origins of the State Arbitration system and the basic outline as to the process of transition in the USSR were covered in detail in the preceding chapter, this material has been omitted from this chapter. Rather, the focus of the discussion of transition is specific as regards the concentration (or rather lack thereof) of market power among the largest firms in the Russian economy and the differing approach to centralization taken by the Putin regime in comparison to that of Kazakhstan. Specifically, how the Russian approach to recentralization was much less reliant on the establishment of state holding companies and state ownership of the country's largest firms than that taken by the Nazarbayev regime in Kazakhstan.

structure of the Russian economy and the relationship of the state to Russia's largest firms, a marked difference from that which took place in Kazakhstan. The Yeltsin era mantra of "take as much sovereignty as you can swallow" gave way to what Putin himself described as, "restoring effective vertical power in Russia,"¹⁷¹ but through means significantly less direct than those utilized by the Nazarbayev regime in the 1990s.

The pattern of center-region relations during the Yeltsin era has received considerable attention in the literature, resulting, perhaps most fruitfully in a series of comparisons with Chinese government policies during the same era. Blanchard and Shleifer have contended that while China maintained a strong set of central controls on the provinces during the early transition era, the Russian federal government under Yeltsin was unable to keep centrifugal forces under check.¹⁷² Montinola, Qian, and Weingast and Qian and Weingast, less helpfully, posited that while China's tax contracting system was market preserving through its stimulation of entrepreneurship among local governments and local economy growth, in Russia this process was essentially market limiting.¹⁷³ Finally, Shleifer contends that center-regional relations

¹⁷¹Vladimir Putin quoted in Nikolas Petrov and Darrell Slider. 2005, "Putin and the Regions" in Dale Herspring (ed), *Past Imperfect, Future Uncertain*, p. 238. New York: Rowman and Littlefield Press.

¹⁷²Blanchard, Olivier and Andrei Shleifer. 2000. "Federalism with and without Political Centralization: China versus Russia." NBER Working Paper No. 7616. Cambridge, MA: National Bureau of Economic Research.

¹⁷³Montinola, Gabriella, Yingyi Qian, and Barry Weingast. 1995. "Federalism Chinese Style: The Political Basis for Economic Success in China," in *World Politics*, vol. 48, no. 1. Qian, Yingyi and Barry Weingast. 1996. "China's Transition to Markets: Market-Preserving Federalism, Chinese Style," in *The Journal of Policy Reform*, pp.149- 185.

were characterized by negative incentives transmitted to the regions through a set of revenue assignments that were based on revenue sharing of all main taxes.¹⁷⁴

However, the most detailed study of the subject was conducted by Daniel Treisman who contends that with the exception of the anomalous case of Chechnya, the center was able to hold Russia together through a process of fiscal appeasement whereby

Figure 4.1: Russian Federal Districts (Okrugs)



tax breaks, credits, and budget allocations were extended to rebellious provinces.¹⁷⁵

Rather than the expected outcome of increased fiscal transfers leading to even greater

¹⁷⁴Shleifer, Andrei. 2000. "Without a Map: Political Tactics and Economic Reform in Russia." Cambridge, MA: MIT Press.

¹⁷⁵Daniel S. Treisman. 2001. *After the Deluge: Regional Crises and Political Consolidation in Russia*. Cambridge: Cambridge University Press.

demands for autonomy, the transfers resulted in a higher level of per-capita spending in those oblasts, okrugs, and krai that received the funds and precipitated increased support for Yeltsin and regional leaders at various critical periods, most notably the 1996 election.

Three key factors comprise Treisman's account. First, the center was able to maintain greater resources and to punish less credible challengers by selectively accommodating those regional leaders who were able to make the most credible threats towards the long-term integrity of the national territory. Second, the chronically underfunded social sector was under regional control and these transfers were able to increase per-capita spending. Third, increases in public support in the regions precipitated increased support for Yeltsin among most regional leaders, but of greatest importance, those leaders who previously had been his fiercest critics. During the 1993 parliamentary crisis, Yeltsin dissolved the Duma and called for new elections resulting in refusals by members of the political opposition to support this program. Each side subsequently called for the support of regional leaders, and in those areas that had benefited from federal transfers, regional governors gave their support to Yeltsin. Through the allocation of social funds, Yeltsin was able to tie provincial political leaders to the Kremlin (at least in the view of the Russian populace) and necessitate their maintenance of close relations with the center in order to ensure the continued flow of revenue in their direction. Treisman's theory, tested empirically via a significant set of

data on center-region fiscal transfers (despite certain problems related to whether he has been able to take account of provincial-level extra-budgetary funds and adequately reconstruct the finances of the provinces in question) has been generally accepted as a sound explanation for center-provincial relations during the Yeltsin era and serves as the jumping off point for understanding subsequent developments in the political economy of Russia during the Putin regime. Ironically, it would be in the regions of Russia which most resisted the offers of the Yeltsin regime and the Big Bang policies of Yegor Gaidar where SMEs would flourish. The SME sector would first take off in these regions, where criminality was low and large firms had minimal power.

The upper Volga region of Ulyanovsk provides a clear example of the process at hand. The provincial government initiated measures that had both short term and long term positive impacts for the development of regional economy. The decline in central control during the Yeltsin era resulted in provincial and local governments having to deal with the fiscal, production, and social implications of the top-down reform policies initiated by Moscow. The “cushioning” policies taken in Ulyanovsk – perhaps best described as a form of semi-autarky - would result in more favorable supply and inflation conditions and lower levels of monopolization and criminalization of the supply system, with knock on effects as regards provincial economic performance and ultimately legal demand.

The Ulyanovsk government utilized its power to control and to stabilize production for local consumption; implemented a mixture of price-controlled and uncontrolled markets for consumer goods; and prevented the undermining of wholesale and retail distribution channels by criminal organizations. Nascent private enterprise was permitted to operate but only under strict conditions and was taxed in order to provide revenue to maintain older firms and elements of the Soviet era social safety net. Rationing of staple consumer goods was implemented and a strict prohibition (enforced by local police inspections) against the shipment out of the province of products deemed essential was enforced. As one of Russia's major food export regions, supplies to the local population could be guaranteed by reducing exports to other regions. As regards local producers, this kept alive relationships with local retail outlets which resulted in the maintenance of a local distribution system. Private SMEs were allowed to sell basic commodities but were not permitted to gain a monopoly position and were required to sell both rationed and price-controlled goods together with more expensive alternatives, thus forcing firms to sell some products at a loss or break even margin in order to sell those items which generated profits. For small business, these policies significantly limited profitability; but the absence of quick, steady profits also managed to keep these firms under the radar of criminal organizations. This system was maintained until the 1997 when the wholesale distribution system was finally privatized by its owner, the city government of

Ulyanovsk and price controls and export controls were removed on all products. By this time, as the underlying infrastructure of the market had been developed, the province had a well-developed base of non-*krisha*, non-criminalized SMEs. The absence of criminalization and the relative strength of the market power of the SME sector would ultimately support the further development of the local economic court system. By 1999, the Ulyanovsk economic courts had the fourth highest number of contract cases in the courts per capita, behind only Moscow, Leningrad (province), and Tula with judges being hired in order to meet the demand. Moreover, unlike other regions in Russia, the private arbitration tribunals established by trade associations and chambers of commerce which became ubiquitous across the country were almost entirely absent from the region. In the course of my field work, I was only able to find one entity in the oblast which had taken on this role. A remarkable state of affairs for a region outside of the country's primary commercial centers. As discussed below, in those Red Belt regions which "cushioned" the Big Bang approach, following policies akin to those implemented in China, the SME sector and the demand for law would develop much faster than in other parts of the Russian Federation.

Market Power and State Ties Among Russia's Largest Firms

Russia's largest firms developed a relationship with the state quite distinct from that of Kazakhstan. In order to facilitate comparison with Kazakhstan, it is useful to begin with a discussion of the resource sector. Gaddy and Ickes provide a thorough

overview of how income derived from the sale of Russian oil and gas on the global market is distributed, how this distribution has changed from the Soviet period through to the present, and how fluctuations in rents have impacted the overall performance of the Russian economy.¹⁷⁶ During the Soviet era, the fact that all firms engaged in the extraction of natural resources were owned by the state resulted in central planners simply allocating rents by means of the pricing system. Subsequent to the collapse of the USSR and the resultant privatization of those firms, the government (both center and provincial) was too weak to administer rent deployment, however rent sharing flourished through the virtual economy. Due to the fact that the property rights of those who owned resource firms were insecure, these individuals required political allies which would ensure the protection of those property rights. The development of such allies was achieved via a process of rent sharing, what Gaddy and Ickes term “relational capital” whereby in order to avoid the loss of all of their wealth the owners of firms shared a portion of their rents locally in order to guarantee that they could keep control over the rest.¹⁷⁷

Upon the accession to office of Vladimir Putin, it was apparent that the economy was entirely dependent upon a few firms controlled by a few oligarchs – similar to the situation in which Kazakhstan found itself before utilizing state revenue

¹⁷⁶Clifford Gaddy and Barry Ickes. 2005. “Resource Rents and the Russian Economy,” in *Eurasian Geography and Economics*, 46:8, pp.559-583.

¹⁷⁷Gaddy and Ickes 2005, p.570.

directed to sovereign wealth funds to acquire ownership or major stakes in the country's big ten firms. Focused on the threat that this presented to his ability to control the country (as opposed to the adverse impact this situation had on the aggregate performance of the Russian economy), Putin undercut the post-Soviet robber barons by removing the objects which they purchased (regional governors) and made manifest a clearly credible threat to their property rights (in the form of his use of the state procuracy against Berezovskii, Gusinskii, and Khordokovskii). The Russian state would ultimately take control over a few large firms, but by and large its sovereign wealth fund under the leadership of German Gref stayed out of making major investments in or taking direct control of Russia's largest firms. Russia's largest firms would have a much more tenuous relationship to the state than in Kazakhstan and control a significantly smaller share of the overall economy. While, as noted in chapter 2, firms owned or partially owned by the state comprise over 60% of the national economy, the share in Russia is significantly lower – less than 10% despite the outsize attention given to such prominent names as Gazprom and Rosneft. As figure 4.2 depicts, Russia's 15 largest firms, scored for state ownership and state ties utilizing the same methods as in chapter, the situation is significantly more diverse.

Figure 4.2: Russia's Largest Firms

Firm	Industry	State	State Ties
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		Ownership/Stake	
Gazprom	Gas	Owned	Yes
Rosneft	Oil	Owned	Yes
Lukoil	Oil	None	No
Surgutneftegaz	Oil and Gas	None	Yes
Norilsk Nickel	Nickel	None	Yes
Tatneft	Oil	Yes (via Republic of Tatarstan government)	Yes
Transneft	Pipelines	Owned	Yes
Novatek	Gas	Stake (via Gazprom)	No
RosTelecom	Telecommunications	None	No
InterRao	Power	Stake (via Rosneft)	Yes
Megafon	Telecommunications	None	No
Novolipetsk Steel	Steel	None	No
Severstal	Steel	None	No
Magnit	Retail	None	No
Sistema	Diverse Trade	None	No

These conclusions are underpinned by a disaggregation of the concept of a resource rent in the Russian economy. Gaddy and Ickes restrict themselves to five

categories of rent: excess extraction costs, price subsidies, informal taxes, formal taxes, and after-tax profit. The division of these particular aspects of resource rent is established via processes of both formal and informal rent-sharing. Concerning the former, the two main components therein are formal taxes and profits. The tax regime on rents under Putin has been remarkably successful in increasing both the relative and absolute amount of rents collected by the state while formal profits of resource firms began to decline, despite higher oil prices, owing to the adoption of new tax rates in the summer of 2004. Informal rents, however, have since sustained a significantly larger portion of the national economy. The components of this “iceberg,” as Gaddy and Ickes refer to the distinctive size of informal rent sharing in the Russian economy, include price subsidies, informal taxes, and excess costs. Due to the continual presence of high rents, particularly informal rents, political actors continue to be consumed by a struggle for control over the distribution. In other words, the largest Russian firms are not directly tied to the state in the same manner as those in Kazakhstan. Rather, these firms compete amongst each other for state preference and one day’s winner can (and has often been) the next day’s target of a tax investigation or a public berating by the Kremlin on the evening news. In the political sphere, both scholars and journalists have cataloged the concentration of power in the hands of the presidential administration, noting that over the last five years, any semblance of the Russian Federation as being a “semi-presidential” system has disappeared, to be replaced with what can only be

called “super-presidentialism.”¹⁷⁸ Similarly, in the economic realm the restructuring of the tax code, the imposition of a flat tax on personal income, and the attendant rise of the tax police as a force to be reckoned with have resulted in significant increases in state revenue without the state taking direct or partial ownership of the country’s leading firms.

Foreign Direct Investment: Supporting Economic Diversification

Foreign investment in Russia began during the Gorbachev era with the passage of the Law on Joint Ventures with Firms from Capitalist Countries in 1987, which was ultimately replaced by the 1991 Law on Foreign Investment in 1991.¹⁷⁹ Initial flows of FDI were slow, according to Goskomstat, by the end of 1992 there were only 2533 foreign firms operating within Russia. The sluggishness of FDI in Russia continued throughout the 1990s hampered by the 1997-98 Russian financial crisis and only began to pick up in the early 2000s. While the Russian government has encouraged FDI in the resource sector in order to update technology and improve the productivity of firms such as Gazprom and Rosneft, unlike Kazakhstan, FDI was directed to a much more diverse number of firms. As figure 4.3 below notes, the resource sector received a comparatively minimal 9.0% of investment. Moreover, FDI as a share of GDP has remained relatively low – comprising only 1.5% of GDP.

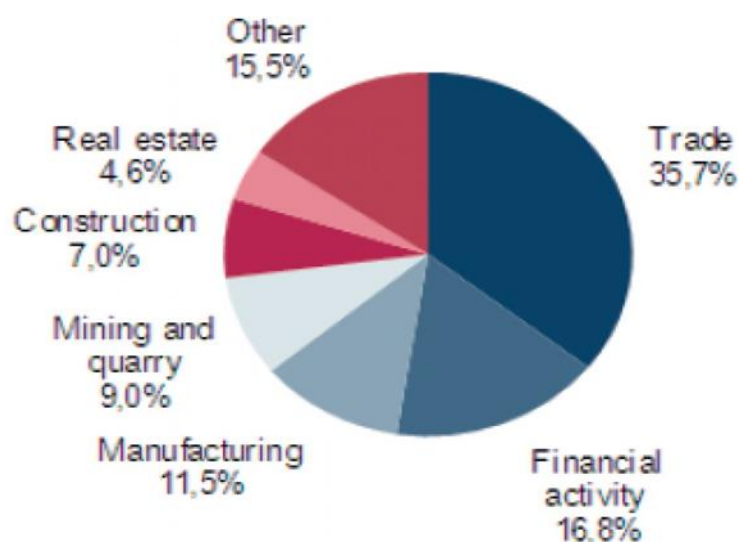
¹⁷⁸M. Steven Fish. 2005. *Democracy Derailed in Russia: the Failure of Open Politics*. Cambridge: Cambridge University Press.

¹⁷⁹ Richard Mirabito. 1989. “Prospects for Western Investment: A Comparison of Joint Venture Laws in the Soviet Union, Yugoslavia, and China,” in *Boston College International and Comparative Law Review*, vol: 12:1.

Figure 4.3: Russian Inwards FDI By Sector (1995-2005)¹⁸⁰

Russian Inwards FDI Structure

By Sector



Source: Central Bank of the Russian Federation

Over the last ten years it has been the industrial sector which has attracted more FDI projects than any other sector. The automotive sector has led the way, with 90 different project and 16,787 job created.¹⁸¹ This was followed by the food sector, machinery and equipment, and business services.

¹⁸⁰<http://www.cbr.ru/eng/statistics/>, originally published in annual report of the Central Bank of Russia, this table is not a creation of the author.

¹⁸¹ Central Bank of Russia. 2015. <http://www.cbr.ru/eng/statistics/?Prtid=svs>

As Yudaeva has shown, FDI in Russia has had significant positive spillover effects on firms in the same industry, facilitating the copying of technology and managerial practices of foreign owned firms through turnover in the labor supply.¹⁸² Moreover, foreign entry has resulted in significant leakage of new technology and managerial techniques for SMEs across the secondary and tertiary sectors of the economy.¹⁸³ Unlike Kazakhstan, where the positive impacts of FDI have been limited to the resource sector and the Big Ten firms, in Russia, Yudaeva has shown that the impacts on large, vertically integrated firms have been minimal. Rather than supporting the concentration of the economy, in Russia FDI has served to buttress the comparative advantage of the SME sector and its long term growth.

The Russian SME Sector: Opening Up the Box

In 1994, the SME sector comprised only 10% of Russian GDP. Since 2004, the number of SMEs has grown from 2.6 million to 4.4 million, contributing an estimated 35% of Russian GDP.¹⁸⁴ While the SME sector remains underdeveloped in comparison to the OECD economies, its contribution to the overall economy of the Russian Federation is significantly higher than the share in neighboring Kazakhstan. However, it is when these numbers are disaggregated by region and type that the relationship to the development of legal demand begins to become clearer. Where in Kazakhstan, the

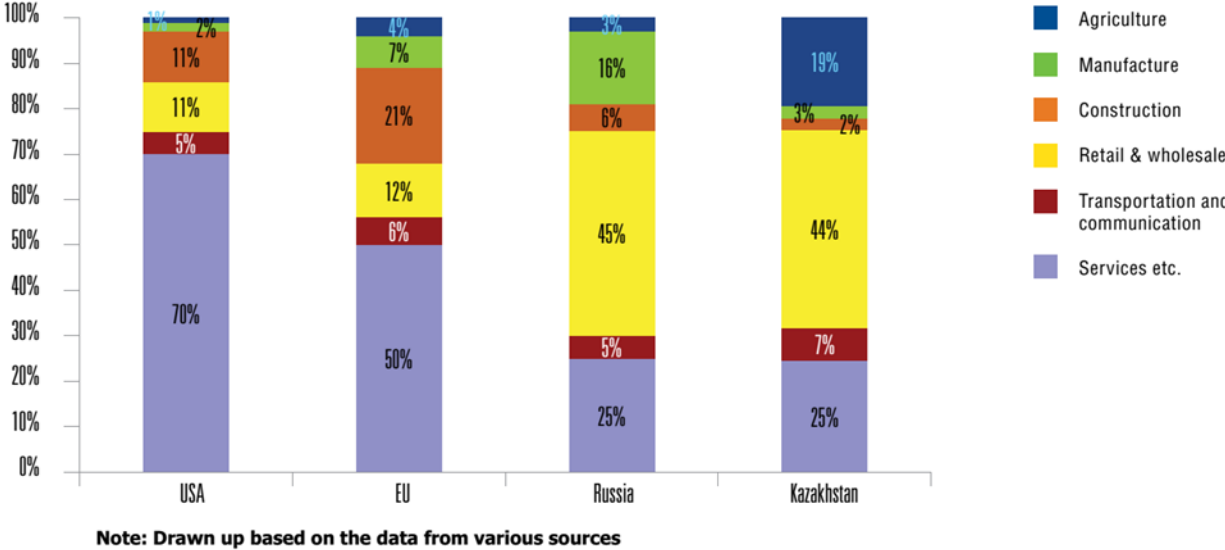
¹⁸²Ksenia Yudaeva. 2003. "Does Foreign Ownership Matter? The Russian Experience," in *Economics of Transition*, vol 11:3, pp. 383-409.

¹⁸³*Ibid*, p. 405.

¹⁸⁴Vladimir Buyev. 2011. "Sbilis so scheta" in *Rossiyskaya Gazeta*, November 22, 2011, <http://www.rg.ru/2011/11/22/dolya.htm>

SME sector remains concentrated, primarily, in micro-enterprises, in Russia nearly 40% of the SME sector's contribution to GDP is attributable to the 16% of firms in the manufacturing sector (see figure 4.4 for comparison of the composition of the Russian and Kazakh SME sectors).

Figure 4.4: Composition of the SME Sector¹⁸⁵

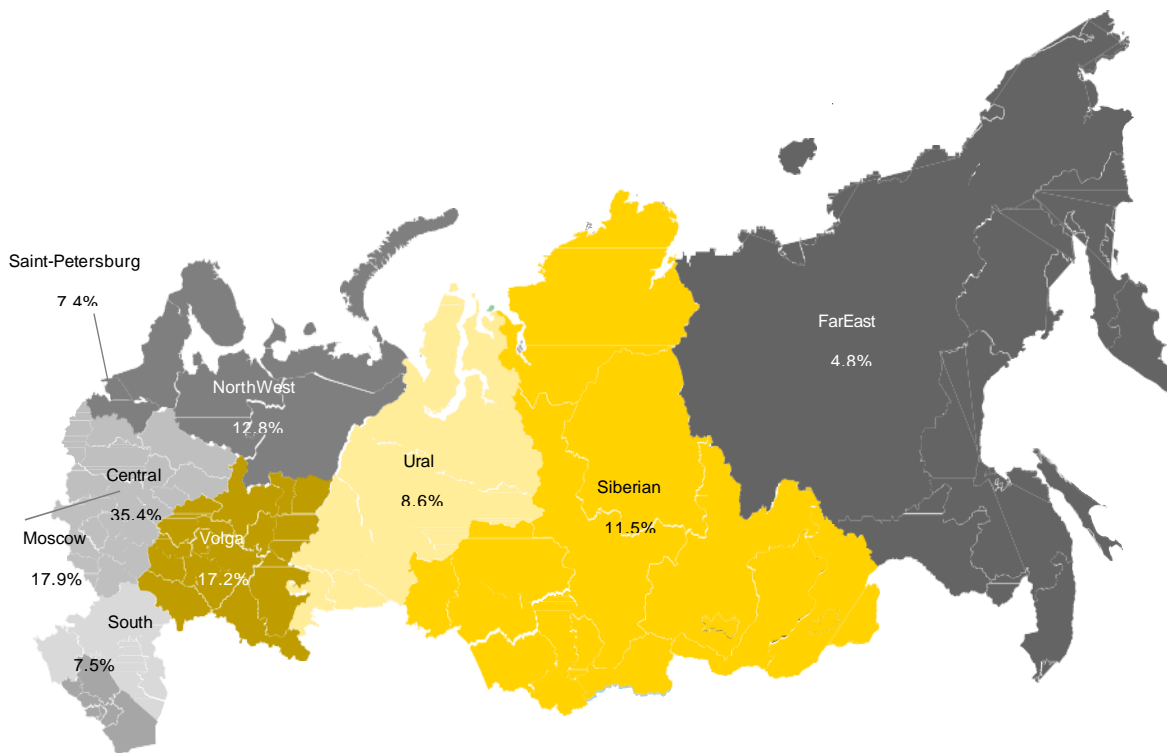


It is also useful to break down these figures by region (see figure 4.5), the SME sector has burgeoned in the heart of the old Soviet “Red Belt,” the Volga Region which now maintains the highest number of SMEs (per capita) in Russia, followed by the Far Eastern District. Both of these regions have been the destination of significant FDI – the

¹⁸⁵ Chart identical to that in chapter two, in report of the Kazakhstan Ministry of Commerce on the development of the SME sector in Kazakhstan. 2014.

former owing to its role as the heart of Russian heavy industry has drawn significant investment from the United States and Germany; while the latter, in light of its geographic location, has seen significant inflows from South Korea and Japan.

Figure 4.5: Breakdown of SME turnover by region¹⁸⁶



The Russian Economic Court System: Increased Demand in the SME Heartlands¹⁸⁷

¹⁸⁶ Map and figures as to the SME strength by federal district in: European Investment Bank. 2013. *Small and Medium Entrepreneurship in Russia*. London: EIB.

In 1992 the Russian Federation replaced the existing system of state arbitration with a set of economic courts with jurisdiction over economic disputes (including contract cases) as well as administrative disputes between firms and the state. Over the course of the 1990s the utilization of these courts by firms actually declined from a high of approximately 320,000 cases per year to 200,000 by 1994 and only returning to the 1992 level in 2003.¹⁸⁸ As has been noted above, the challenges of corruption and political influence in the courts deeply undermined legal demand. Hendley notes an interview with a Moscow auto parts factory manager who argued that “it was pointless to sue the giant auto assembly plants on their home turf,”¹⁸⁹ while the manager had no direct evidence, the belief was sufficient to keep him away from using the courts. If this is in fact the case, as survey work across the Russian Federation in the 1990s has noted, why has there been such a significant increases in the total number of cases in the arbitration courts? How did a moribund economic court system shift from minimal legal demand to a record 1.3 million cases being brought before the courts in 2014¹⁹⁰?

As Hendley has noted with regard to the utilization of the courts in contrast to existing, informal mechanisms of dispute resolution: “the shift to a reliance on law makes sense only if it is made almost simultaneously by a substantial majority of

¹⁸⁷ Please refer to chapter 2 for a summary of the development of the State Arbitration System before the collapse of the USSR.

¹⁸⁸ Supreme Arbitrazh Court of the Russian Federation. 2015. *ОСНОВНЫХ ПОКАЗАТЕЛЕЙ РАБОТЫ АРБИТРАЖНЫХ СУДОВ РОССИЙСКОЙ ФЕДЕРАЦИИ*, http://www.arbitr.ru/_upimg/724306690007BEE7080EE56EAB938A93_1.pdf

¹⁸⁹ Kathryn Hendley. 1999. “Rewriting the Rules of the Games in Russia: The Neglected Issue of Demand for Law,” in *Eastern European Constitutional Review*, vol. 8, p. 92.

¹⁹⁰ Supreme Arbitrazh Court of the Russian Federation, 2015.

potential litigants. Managers are understandable reluctant to make the move, thereby ceding advantage to law-adverse trading partners who could still appeal to political or other patrons. The safer option is to stay the course.”¹⁹¹ The data from Russia indicates that this shift has taken place; however, it is has not been universal across all provinces and federal districts. Rather, in regions where SMEs maintain significant market power, there has been an increase in legal demand. I hypothesize that the reasons for this are two-fold: (i) SMEs are utilizing the courts in disputes with other firms of relatively equivalent market power and (ii) Regions with a higher proportion of SMEs are able to balance out the relative strength of larger firms through business associations which are able to act as a check on political influence in the courts. The absence of disparity in market power in regions eliminates the collective action problem suggested by Hendley; while in those regions where there remains elements of disparity between SMEs and large, resource based firms, the challenges of potential political influence on the courts are overcome through the strength of business associations. In addition, the growth in legal demand in the Russian Federation has tracked the expansion of the SME sector.

It is helpful to begin here with the case of Ulyanovsk discussed at the outset of this chapter. The “cushioned” approach to transition in the province, as noted above, facilitated the growth of the SME sector in the early years of transition, with firms

¹⁹¹ Kathryn Hendley. 1999. “Rewriting the Rules of the Games in Russia: The Neglected Issue of Demand for Law,” in *Eastern European Constitutional Review*, vol. 8, p. 94.

organizing a provincial economic association in 1993. By 2001, the SME sector accounted for 41% of provincial GDP,¹⁹² significantly above the national average of 17%. While legal demand dropped throughout the 1990s across the Russian Federation as individuals and businesses avoided the courts, the Ulyanovsk economic courts in Simbirsk and Dmitrivograd, the province's two main economic centers, saw a decline of only 17% (against a national decline of 46%) and a return to 1992 levels of court utilization by 1999 with consistent year on year increases since that time.¹⁹³ Ranked for the per capita number of contract cases, the province comes in 5th nationally. Ulyanovsk is an extreme case, but the other provinces of the Volga Region, with similar levels of relative market power in the SME sector have also seen consistently higher levels of legal demand. While the overall statistics for the increase in legal demand across the Russian Federation show a remarkable increase in the utilization of the courts, it is imperative to recognize that increase has not been equally distributed across the country as a whole. Rather, the bulk of that uptick is found in regions where the SME sector is stronger, i.e. the Volga region and the Far Eastern Region (excluding the province of Sakhalin). While the Volga region accounted for only 15.3% of Russian GDP in 2012, its share of the national total of contract dispute cases in that year was 19.7% with SMEs accounting for (excluding the grey economy) 37% of regional GDP. The Far

¹⁹² Central Bank of Russia. 2001. *Annual Statistical Yearbook*. Moscow: Central Bank of Russia.

¹⁹³ Data obtained from the annual administrative reports of the Simbirsk and Dmitrivograd Arbitrazh Courts in March 2011 and via interviews conducted in those two cities at that time.

Eastern Region in that same year provided a comparatively minimal 5.5% of GDP, yet its share of contract dispute cases was 8.2%. The cumulative contribution of SMEs to the regional economy was 32.8%. This stands in marked contrast to the Siberian Federal District, the heartland of the Russian resource sector, which contributed 10.5% of GDP with SMEs responsible for 13.7% and a relatively minimal share of the total number of contractual disputes in 2012 in the Russian Federation: 8.5%.

Figure 4.6: Market Power and Contract Cases (Top 5/Bottom 5 Federal Subjects)¹⁹⁴

Federal Subject	Resource Market Power	Legal Demand Rank/Score
Moscow	9%	1 (1145.46)
St. Petersburg	6%	2(1027.60)
Samara	14%	3 (1011)
Khabarovsk	17%	4 (954.21)
Ulyanovsk	9%	5 (934.46)
YamaloNenets	89%	81(145.64)
Chukotka	72%	80 (152.32)
Norilsk	64%	79 (208.56)

¹⁹⁴ For the purposes of data presentation, only the top and bottom 5 are shown. The Caucasus provinces which rank as the bottom 4 in term of contract cases per annum (Dagestan, Chechnya, etc) have also been excluded as these regions, owing to their consistent political instability and continued violence, face severe challenges not found in other parts of the Russian Federation creating severe problems as regards comparability.

Sakhalin	58%	78 (245.10)
Khanty-Mantsisk	94%	77 (253.69)

When breaking down the data at the provincial level, the divisions become even clearer, particularly with regard to the lack of legal demand in regions where the economy remains dominated by large, state tied resource based firms. The Russian Federation is comprised of 85 federal “subjects,” i.e. republics, okrugs, krais (territories), and oblasts (provinces). The three regions where the resource sector maintains the highest share of market power are: Tyumen, the Yamalo-Nenets Autonomous Okrug, and the Khanty-Mantsisk Okrug. These three areas serve as the core of the Russian oil and gas sector and their economies are dominated by the firms Gazprom and Rosneft. The scores for the market power of the resource sector (i.e., percentage of GDP in 2012) were 74% in Tyumen, 89% in Yamalo-Nenets and 94% in Khanty-Mantsisk. Despite the presence of significant (non-resource) industrial firms in Tyumen, owing to the sheer scale of the oil and gas refining industry in the region, their contribution to provincial GDP remains relatively low. When ranked for the number of contract cases brought before the economic courts, these three regions cluster at the bottom of the league table at 72, 81, and 77 respectively - only beating out the republics of the Caucasus region (which are unique in light of their decades-long security issues).

Does this necessarily mean that large resource firms are inherently “poison” for legal demand? The case of the republic of Bashkortostan provides an interesting counterpoint. Although the republic is a major center of oil and petrochemical production (contributing 21% of Russia’s supply of gasoline), its economy is highly diversified. While SMEs remain roughly on par with the national average, contributing 20% of GDP in 2012, the resource sector contributes a comparatively low share at 34% with the remainder provided by the province’s large agricultural sector, a growing service economy, as well as light and heavy industry. Rosneft and its subsidiary firms are responsible for the bulk of the province’s oil production, yet Bashkortostan still ranks in the upper half of provinces as regards legal demand, scoring at 34 out of the 85 federal subjects; illustrating that large firms with state ties but without dominant market power are insufficient to undermine legal demand.

The Comparative Weakness of Private Arbitration

While in Kazakhstan, the private arbitration tribunals have continued to grow throughout the 2000s, the situation in Russia has been quite different. Business associations and local chambers of commerce have provided private tribunals for the resolution of commercial conflict, with the Chamber of Trade and Industry creating one of the first private tribunals in 1992. The role of these institutions was formalized in 2002 with the adoption of the Law on Private Arbitration. At that time an estimate 400 private arbitration tribunals were estimated to be in existence at that time. While in

Kazakhstan in 2014, the number of private arbitration cases topped 10,000 for the first time (based on the number of requests for enforcement of decisions by the economic courts)¹⁹⁵– in Russia utilization of this form of dispute adjudication has not been nearly as popular. In 2013, the number of cases where a request was made for enforcement by the economic courts was a relatively miniscule 4,570 – particularly small in light of the vast disparities in size in the Kazakh and Russian economies.¹⁹⁶ Where Kazakh firms have sought refuge in private arbitration lowering demand for law, Russian firms have primarily turned to the state court system.

Conclusions

The Russian arbitration courts are presented as a story of comparative success in light of the enormous increase in cases submitted to these bodies over the last decade. However, that increase has not been equal across all federal districts. Rather, the increase is disproportionately high in regions with a greater market power in the hands of SMEs and where state tied, resource conglomerates have minimal market power. Unlike Kazakhstan, the Russian economy has become considerably more diverse with an expanding industrial sector and FDI levels into that sector which made the country the third largest recipient of FDI in 2012 and 2013. In those provinces which remain dominated by state-linked resource firms, the demand for law remains weak; however,

¹⁹⁵ This figure is only inclusive of cases that ended with a request for enforcement of the decision through the bailiff service of the economic courts, it does include cases that did not use courts for enforcement – indicating a higher number of cases than the 10,000 or so noted above.

¹⁹⁶ Supreme Arbitrazh Court of the Russian Federation. 2015. *Annual Statistics of the Arbitrazh Courts*. Moscow.

the greater diversity of the Russian economy, particularly the relatively large role played by medium sized industrial firms provides support for the conclusion that the presence of large resource firms is not necessarily a “curse” for the development of the demand for law. Rather, if the market power of those firms is checked by a large SME sector and/or a significant, non-state tied, private industrial sector – demand for law does not appear to be negatively impacted.

Chapter Five

Conclusions: Supply, Demand, and the Legal Reform

Introduction

This dissertation contends that the demand for law rather than the supply of law must be placed at the center of contemporary discussions as regards legal reform and the technical assistance programming activities of bilateral and multilateral institutions seeking to support that reform. As noted in chapters two and three, attention has been primarily paid to the supply of law rather than the conditions that legal demand. While the salience of legal demand has been demonstrated across multiple studies within the political science literature over the past decade, the causal variables which support that demand have remained unclear. Building on the Varieties of Capitalism literature and the question as to the causal implications of differing modes of organization in national economies as regards institutions and institutional reform, I have contended that the dominance of the economy by a small number of large firms with significant market power undermines the demand for law and locks these states into a type of low level equilibrium trap whereby no amount of new legal supply is able to build the rule of law. As depicted in the case of Kazakhstan, the continued provision of “supply of law” has not resulted in increases in utilization of the courts in those regions where the economy is dominated by a few large firms with high levels of market power. Conversely, despite rapid economic growth which would normally entail increased

activity in the courts, the demand for law in areas where the economy is dominated by large firms with significant market power remains either stagnant or negative.

Rather than relying on the mass of conflicting survey data as to perceptions of the courts by domestic and international actors, this dissertation has utilized data from the commercial courts and arbitration tribunals in order to demonstrate this relationship at both the national and subnational levels across the various regions of Russia and Kazakhstan. By employing a sub-national, comparative approach, this dissertation is able to make conclusions that are relatively more robust than studies that rely on cross-national comparisons which are empirically bedeviled by the problems of differing national legal cultures and systems of law.

Concomitantly, this project raises a set of corollary points as regards the role of FDI in long term development. Rather than viewing FDI as inherently positive for economic development, I have contended that it is necessary to disaggregate FDI by type. In countries such as Kazakhstan, the outsized gains that multinational resource firms can achieve through investment in the resource sector have incentivized significant investment towards this sector and has resulted in an economy entirely dominated by ten large firms. Owing to large firm controls over capital – as illustrated by the Herfindahl-Hirschman Index figures for the Kazakh banking industry - the expansion of the SME sector has been effectively hobbled in Kazakhstan. This conclusion supports that strand of the FDI literature that has argued that gains from

FDI are dependent on the existence of developed financial markets and highlights the problems with the hypothesis that increases in FDI inherently support greater access to capital throughout the economy as a whole.¹⁹⁷ This point is buttressed by the case of Russia. Investment in the Russian economy, while initially heavily directed towards major resource conglomerates, gradually diminished over the first decade of transition. FDI was increasingly directed towards the SME sector and the establishment of local subsidiaries of foreign firms. The economy diversified, shifting away from the sort of large conglomerate dominance that was observed in Kazakhstan and subsequently the demand for law increased. However, in those regions – Khanty-Mansisk, Sakhalin, Norilsk, and Yakutia – where large, politically tied resource firms have dominated, demand for law has remained weak. Since the mid-2000s, the demand for law has broadly risen throughout those regions which maintain a higher level of economic diversity, i.e. a more developed SME sector. No specific threshold has been defined here as to what percentage of the economy needs to be contributed by the SME sector in order to facilitate demand nor as to at what threshold market concentration undermines legal demand, that question will have to be explored through subsequent large-n analysis. Nevertheless, a causal relationship and clear causal mechanisms have been demonstrated through the small-n, case study approach taken here.

¹⁹⁷ Mohammed Amin Alfaraji and Mahmud Almsafir. 2013. "Foreign Direct Investment and Economic Growth Literature Review from 1994 to 2012," *Procedia - Social and Behavioral Sciences*, vol. 129, pp. 206-213.

Beyond the confines of the literature on the transition economies, this relationship between economic structure and legal demand is of value that body of literature which contends that legal reform initiatives must be examined and organized with greater attention towards the realities on the ground in less developed economies. The empirical relationship between legal demand and the structure of the economy adds further evidence in support of the literature in political science, which contends that there exists a process of co-evolution between the legal system and the economy. High levels of market concentration among a small number of firms as an aspect of an economy, as illustrated in Kazakhstan and Russia, has deleterious implications as to legal demand. Absent that legal demand, the development of the rule of law becomes impossible in that legal supply remains ineffective and simply remains as “law on the books.” Countries remain mired in corrupt and inefficient legal systems for decades on end. Future discussions as to the building of the rule of law in less developed economies will need to incorporate a more explicit recognition of the causal role played by the concentration of market power as an impediment and the SME sector as an impetus.

Finally, the conclusions reached herein have implications for the study of institutions and institutional reform within the discipline of political science. Two aspects are particularly germane: technical assistance for legal reform and the relationship of FDI to judicial systems. The findings of this dissertation as regards each

of these topics are discussed below, together with summaries as to potential directions for future research.

Of Carts and Horses: Re-Thinking Technical Assistance for Legal Reform

William Easterly has estimated that that the West has spent \$2.3 trillion on overseas aid over the last five decades; a significant portion of these funds have been directed towards legal and judicial reform technical assistance activities.¹⁹⁸ Channell has summarized the legal reform experience in the transition economies:

“It is hard to imagine any rule of law aid specialist pursuing law reform in his or her own country in this fashion. If I assembled half a dozen recognized European or US specialists to redraft the US Code of Judicial Ethics and then tried to get it passed by the US Congress with little or no input on the proposed draft from congressional committees, the judiciary, the bar, business interest, law schools, or other stakeholders, I would be looking for a new career rather quickly. Based on many current practices, however, that career could easily be found abroad 'helping' transition countries with the same process.”¹⁹⁹

Channell’s point is closely tied to Easterly’s analysis as to why overseas aid policy has not resulted in the outcomes so often mooted by its supporters: a top-down approach that ignores the diverse realities on the ground. This dissertation echoes those concerns in presenting the case for understanding the dynamics behind legal demand and the importance of recognizing how legal demand develops differently in different types of economies. This dissertation rejects the more pessimistic view that foreign aid in support of institutional reform is inherently doomed to failure. Rather, I argue that

¹⁹⁸ Easterly 2006, p. 26.

¹⁹⁹ Wade Channell. 2005. *Lessons Not Learned: Problems with Western Aid for Law Reform in Post-Communist Countries*. Carnegie Endowment for International Peace, Democracy and Rule of Law Project, No 57, May 2005, p. 6.

institutional reform efforts are feasible provided that a “bottom up” approach, which begins by looking at the organization and landscape of the national economy, is adopted.

As noted in chapters one and two, information as to the outcomes of legal supply programing has often been contradictory. Survey work as to the state of the rule of law, levels of corruption, the quality of the judiciary, and the actual experience of the individual/firm utilizing the courts have been anything but consistent. This has resulted in decision making that is undertaken with a rather weak understanding of on the ground conditions and unclear standards of evaluation as to outcomes, ultimately entailing the continuation of a legal supply approach with very little to justify the enormous amounts of funding allocated to those activities.

Easterly’s conclusions provide useful insights for those examining the evolution of the institutions that support the market in the post-socialist world.²⁰⁰ Markets can function badly for a panoply of reasons. Detailed knowledge of local conditions is necessary in order to avoid the various, potential pitfalls waiting around every corner. For Easterly, it is simply impossible to avoid these when engaged in sweeping, top-down, large-scale reform initiatives. Instead, he contends that the emergence of a successful market should be seen as a “gradual progression in which market

²⁰⁰ This point will come as no surprise to any observer of the transition process in the former Soviet Union and the debates discussed in chapter one as to the effects of the Big Bang theory. The challenges of implementing top down market reform have been well discussed. Peter Reddaway and Dmitri Glinski. 2001. *The Tragedy of Russia’s Reforms: Market Bolshevism Against Democracy*. Washington DC: US Institute of Peace.

participants seek locally viable solutions to a range of standard economic problems.”²⁰¹ Rather than supporting institutional reform initiatives that are theoretically able to move a state from sub-optimal point A to optimal point B (as seen in the case of legal supply initiatives), processes of reform might necessitate a longer process with significant periods of time utilizing better but still somewhat inefficient institutions. In other words, a process of moving from point A to B to C to D and so on. In the typical case of reform failure, a top-down effort to fast-track reform results in the imposition of a set of formal rules that subsequently fail due to a lack of understanding of local conditions, and manage to make things worse by undermining a nascent but potentially successfully evolving informal system.

This process can be observed quite clearly in the case of Kazakhstan where technical assistance was provided and continues to be provided in the form of the supply of law: a new civil code, training for judges, revisions to various statutes and regulations, investment in infrastructure, etc. Unlike Russia, where state arbitration was “repurposed” and converted into the current system of economic courts, Kazakhstan’s state arbitration system was officially abandoned and a new commercial judiciary was created *ex nihilo*. Kazakhstan can be seen as the paradigmatic case for top down, legal supply programming, wherein the transplant of best practices and the supply of law became the hallmark of technical assistance with minimal attention paid to the users of

²⁰¹ Easterly 2006, p. 83.

the law and the day to day practices of local firms and entrepreneurs. The failure of the top-down, supply based model in Kazakhstan (as measured by stagnant legal demand); the “flight from courts,” and the growth of a trusted and well utilized system of private arbitration in the country very much dovetails with Easterly’s “multiple steps” conceptualization of institutional reform and raises questions as to potential alternatives for legal reform generally as well as the options for those economies that maintain deleteriously high imbalances of market power that diminish legal demand and harm the long term development of state courts.

At the most general level, the focus of this dissertation as to the causes of legal demand would seem to fit Easterly’s requirements to move away from top-down initiatives and to shift focus to the realities on the ground in less developed economies. At the same time, taking Easterly’s point that “the free market depends on the bottom-up emergence of complex institutions and social norms that are difficult for outsiders to understand, much less change”²⁰² as a starting point, the salience of the Kazakh case becomes apparent, i.e., the gradual emergence, out of the remains of the state arbitration system, of private arbitration institutions for the resolution of contractual disputes. Two points can be made here. First, greater attention should be paid to pre-reform modes of contract adjudication and the potential that these institutions hold as “second best” options when the conditions necessary to support legal demand (and

²⁰² Easterly 2006, p. 56.

ultimately legal reform) are not present. In the case of Russia, as noted in chapter three, elements of the state arbitration system – specifically the large body of attorneys trained in the Soviet body of economic law – served as alternatives to a poorly functioning system of state economic courts throughout the early 1990s. Firms were able to utilize a model of adjudication which had been in place for sixty years and with which economic actors were familiar as reforms were made to the court system. In this case, legal supply still plays an important role; however, absent this alternative option, Russia would not have seen the expansion of the SME sector which led to the legal demand necessary to support the development of the economic courts. Nevertheless, this dissertation does not go as far as others working in the field of post-Soviet political economy who have argued that contemporary institutional outcomes can be directly traced back – genealogy-like – to the particular critical junctures when Soviet institutions were first established.²⁰³

Those economies that do not have a sufficiently large SME sector to facilitate legal demand are not necessarily “legally doomed.” However, the outlook is certainly grim in the near term for the development of the formal court system. The provision of the supply of law when the variable of market power by a few large firms obtains is likely to result in low levels of legal demand insufficient to support the development of

²⁰³ This approach has in other cases shown itself to be effective but does not hold the same causal weight as regards questions of legal reform. David M. Woodruff. 2000. *Money Unmade: Barter and the Fate of Russian Capitalism*. Ithaca: Cornell University Press.

the court system. Rather than focusing on that formal judiciary, reform initiatives should therefore begin to be directed towards improvement of and the further expansion of the private arbitration system, i.e. an intermediate term set of legal institutions that while not ideal are able to provide timely, trusted, and efficient resolution of contractual disputes. Historically, support for private arbitration by aid agencies has been limited to international arbitration to facilitate foreign direct investment; however, in recent years technical assistance for private arbitration has begun to find its place, particularly in states where rule of law reforms have shown themselves to be consistently unsuccessful.²⁰⁴

As noted in chapter three, SMEs in Kazakhstan have found an alternative that serves their needs for a mechanism for contract adjudication and have actively pushed for its expansion. This was most clearly illustrated in the conflict over laws governing the enforcement of the decisions of arbitral tribunals in Kazakhstan, wherein the bailiff laws were eventually revised to facilitate the enforcement of these decisions by the state bailiff system, a division of the state judiciary. These tribunals can be understood as co-evolving in tandem with the SME sector. As private arbitration provides a mechanism for the resolution of contractual disputes, commerce expands beyond the local level,

²⁰⁴ IFC. 2009. *The Establishment of Commercial Arbitration Services in Cambodia*. Washington DC: International Finance Corporation. Rozdeiczer, Lukasz and Alejandro Alvarez de la Campa. 2006. *Alternative Dispute Resolution Manual: Implementing Commercial Mediation*. Washington DC: International Finance Corporation. Paul Shaughnessy. 2006. "Promoting Effective Arbitration Through Legal Assistance Programs," in *Arbitration International*, vol. 22:2.

arms-length contracting becomes possible, and the SME sector is able to expand, diminishing the market dominance of large scale firms and their influence over the formal judiciary. In other words, private arbitration should be able to support the necessary changes in the structure of the overall economy which will ultimately lead to increases in legal demand and improvements in the formal judiciary. Legal reform cannot be conducted in a cart before the horse manner, i.e. providing supply before adequate demand has developed. Rather, alternatives to the formal court system should increasingly be considered in order to facilitate that demand when possible. This question of interventions in support of the development of the SME sector extends as well as to the role of FDI and the institutions which support and in some cases underwrite that investment.

FDI, Legal Demand, and Policy Coordination

One of the strongest bodies of research guiding contemporary work in legal and judicial reform is that which has focused on the question of global economic integration as a means to facilitate development. FDI and its role has been at the center of this body of literature which has primarily explored the implications of FDI on economic growth. The evidence has been somewhat mixed, but generally positive. This dissertation has built on that work by asking two new questions that have received very little attention so far: (i) what are the implications of FDI for legal demand and (ii) do all forms of FDI have identical impacts on legal demand?

Caves' pioneering work on the broad subject of FDI and economic development four decades ago concluded that there exists a positive correlation between the productivity levels of multinational firms operating in less developed economies and the value added per worker among domestic firms within the same sector.²⁰⁵ He subsequently demonstrated that the positive impacts of FDI – access to markets, technology transfers, the introduction of new production processes, productivity gains, etc. – resulted in state efforts to attract more of it.²⁰⁶ These efforts included commitments to improve the quality of institutions in general and the courts in particular. However, actions to improve legal institutions were inherently based around the supply of law rather than increasing legal demand, leaving the latter issue unexplored and casting doubt on the efficacy of FDI as a driver of legal reform.

More recently, Borensztein demonstrated that FDI, via technology transfer, is responsible for a larger percentage of growth than domestic investment across a panel of non-OECD economies.²⁰⁷ While a positive outcome, as seen in the case of Kazakhstan, growth by itself does not necessarily result in increases in legal demand and can end in an actual decline in the utilization of the courts as market power becomes ever more concentrated. At the same time Rappaport, building on Caves' initial work, has pointed out that FDI may improve the productivity not only of the firms receiving investments,

²⁰⁵ Richard E. Caves. 1974. "Multinational Firms, Competition and Productivity in the Host Country," in *Economica* 41: 176-193.

²⁰⁶ Richard E. Caves. 1996. *Multinational Enterprise and Economic Analysis*. Cambridge University Press.

²⁰⁷ E.J. Borensztein. 1998. "How Does Foreign Direct Investment Affect Economic Growth?" in *Journal of International Economics*, vol. 45: 1, pp. 115-135.

but also of all firms owing to technological spillovers stemming from inter-industry externalities and through forward and backward linkages.²⁰⁸ With regard to the resource industry, Sun and Shan have, respectively, provided empirical support for the contention that when FDI flows to the petroleum sector, domestic investment in related industries increases; the former finding a strong correlation between FDI and domestic investment in China while the latter has shown the benefits to the Chinese economy when ratio of FDI to industrial output increased.²⁰⁹ While this conclusion is positive as regards growth, again it is important to underline the point that growth does not guarantee improvements in the level of legal demand – a greater number of economic transactions alone is insufficient.

This general acclamation of the effects of FDI is, nevertheless, increasingly conditioned. Blomstrom argues that the positive effects of FDI on growth only seem to be present when a country passes a specific threshold level of income, highlighting that only those state at a certain income level could utilize new technologies and benefit from diffusion effects.²¹⁰ Perhaps most germane to this project is the conclusions of Alfaro, i.e. that the benefits of FDI only occur in states with well institutionalized

²⁰⁸ Jordan Rappaport. 2000. "How Does Openness to Capital Flows Affect Growth?" Research Working Paper, RWP 00-11. Kansas City: Federal Reserve Bank of Kansas City. Beata Javorcik. 2004. "Does Foreign Direct Investment increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages" in *American Economic Review*, vol. 94:3, pp. 605-627.

²⁰⁹ J. Shan. 2002. "A Macroeconomic Model of Income Disparity in China," in *International Economic Journal*, vol 16:2, pp. 47-63. H. Sun. 1998. "Macroeconomic Impact of Direct Foreign Investment in China: 1979-96," in *The World Economy*, vol. 21:5, pp. 675-94.

²¹⁰ Michael Blomstrom. 1994. "What Explains Growth in Developing countries?" NBER Discussion Paper 1924. Cambridge, MA: National Bureau of Economic Research.

financial markets.²¹¹Alfaro's work provides support for the contention of this dissertation that FDI's effects are not inherently positive as regards legal demand and the development of the SME sector. This body of work also helpfully frames the current debate as to whether institutional reform follows FDI or whether increases in FDI result from successful institutional reform. The evidence has been mixed. FDI is understood to contribute to institutional development through numerous mechanisms. Via lobbying, foreign investors are able to pressure governments to change existing institutions, e.g. liberalizing investment regulations and establishing more general laws that induce more comprehensive legal reform. In the case of the Eastern European economies, these types of interventions were shown to have a positive effect on the trajectory of legal reform, although discussion of legal demand was absent.²¹² Additionally, these sorts of direct effects have been seen in Kazakhstan when, as discussed in chapter two, foreign firms successfully pressured Astana to revise the regulations governing international arbitration to ensure the enforceability of these decisions within the country.

Increasingly attention has been paid to the types of institutions that encourage foreign investment and the strong correlation between weak institutions and the

²¹¹ Laura Alfaro. 2003. "FDI and Economic Growth: The Role of Local Financial Markets," in *Journal of International Economics*, vol. 61: 1, pp. 512-33.

²¹² Carl H. McMillan. 1993. "The Role of Foreign Direct Investment in the Transition from Planned to Market Economies," in *Transnational Corporations*, vol: 2, pp. 97-119.

volatility of FDI²¹³ as well as the debate as to whether institutional quality facilitates FDI or vice-versa.²¹⁴ This dissertation has not sought to answer the “chicken vs. egg” question noted above. Rather, it has questioned the received wisdom that FDI *consistently* serves to facilitate the strengthening of legal institutions through a process of diffusion of best practices and increases in the demand for law. FDI purportedly incentivizes firms to utilize formal legal institutions and to engage in “lawful business” through the possibility of an initial public offering (IPO) on a foreign stock exchange and increased access to capital. Cross-country and in-country studies have contended that FDI is therefore an unambiguous good, supporting the development of legal systems which allow firms to optimally vertically integrate, capture an increasing share of global trade through efficiency gains, and contribute to economic growth ultimately further increasing FDI in a virtuous circle.

Conversely, in this dissertation as a corollary to the issue of market power, I have argued that global economic integration and FDI often have negative implications for legal reform and the structure of the local economy stemming from investments that can result in increased market power on the part of a few firms, greater the centralization of the economy and the undermining of the development of the SME sector. How FDI impacts the distribution of market power in a less developed economy

²¹³ Bonnie Buchanan, Quan Le, and Meenakshi Rishi. 2012. “Foreign Direct Investment and Institutional Quality: Some Empirical Evidence,” in *International Review of Financial Analysis*, vol: 21, pp. 81-89.

²¹⁴ Agnès Bénassy-Quéré, Maylis Coupet, and Thierry Mayer. 2007. “Institutional Determinants of Foreign Direct Investment,” in *The World Economy*, vol. 30: 5, pp. 764-782.

needs to be incorporated into any analysis of legal reform as well as in the planning of technical assistance initiatives. In the cases of Kazakhstan and Russia, the rapid inflow of FDI had severe implications nationally for the former and regionally in the case of the latter. An essential take away of this dissertation is that development policy cannot be viewed in a vacuum, excluding other elements of overseas economic policy – rather, it is necessary to more deeply grasp the implications on the ground and revise policy prescriptions in light of these outcomes. The role of FDI is positive as regards legal demand when it is directed towards the SME sector or results in pressure on the state to permit the operation of alternative forms of dispute resolution (e.g. private arbitration) outside of the civil courts.

It is therefore essential to pay greater attention to how FDI will impact market power/concentration, the SME sector, and legal demand and to ensure that FDI is not working at cross-purposes with other forms of technical assistance. Easterly and Banerjee have highlighted the problem of lack of coordination among development agencies despite the increased attention paid to this issue in recent year.²¹⁵ In this case, OECD economies continue to support FDI as a core component of development through subsidized insurance programs such as the Overseas Private Investment Corporation (OPIC) in the United States and the World Bank's Multilateral Investment Guarantee Agreement (MIGA). At the same time, capacity building/legal supply

²¹⁵ Easterly 2006, p. 12.

programs in less developed countries, as noted above, are a core component of poverty reduction plans and long term development strategies implemented by development agencies. Rather than working in congruence to support the improvement of legal systems, these programs appear to be working against one another – with the deleterious effects of FDI on legal demand making the effects of capacity building programs, at best, moot.

As the cases of Kazakhstan and Russia demonstrate, when FDI is primarily directed towards large scale resource firms, the contours of the domestic economy of the recipient economy will shift and imbalances in market power can develop (or become exacerbated) and undermine the SME sector and the development of legal demand. Programs such as MIGA and OPIC, which underwrite political risk insurance for firms investing in LDCs, should begin to include in policy matrices and poverty reduction strategy papers the share of underwritten investment towards this sector. The European Bank for Reconstruction and Development (EBRD) has been a pioneer in this area, already having shifted the focus of its private sector programming towards the SME sector.²¹⁶

Final Conclusions and Future Directions for Research

This points raised in this dissertation as regards the challenges of building demand, the ineffectiveness of legal supply, and the complex implications of foreign

²¹⁶ The recent announcement of the EBRD SME support initiative is illustrative of this shift: <http://www.ebrd.com/small-business-support.html>

direct investment will hopefully contribute to the burgeoning literature on new ways to do development policy. Kathryn Hendley's point, set out in chapter two, as to the importance of more case study oriented research on legal reform fits well with Easterly's contentions concerning the importance of gaining better information as to the realities on the ground in the developing world in order to better design and implement technical assistance programs. The countries of the former Soviet Union will continue to face significant challenges in the development of their legal institutions and new approaches beyond the existing legal supply regime will need to be implemented if multilateral and bilateral agencies are to contribute to successful reform. It is my contention that acknowledging the diversity of the structure of national economies and the diverse impacts thereof is essential to the success of those reforms. Recognition of the co-evolution of the law and the economy and incorporating that insight into policy initiatives is increasingly a pre-requisite for success, rather than an optional extra.

Lastly, having demonstrated the causal relationship between concentrated market power and legal demand through a small-n study, next steps include the completion of large-n comparative analysis across the set of post-socialist economies. Also, it will be important to further examine the conditions that lead to firms deciding to use the courts and the barriers that undermine that demand beyond the issues of trust discussed in this dissertation. The development of private arbitration institutions in the post-socialist world – most notably in Cambodia and Kazakhstan also need to be

explored in more detail if their development is to serve as a stepping stone towards the building of efficient court systems and the rule of law rather than as simply a permanent, stop gap measure. It is also essential to understand the conditions under which private arbitration is able to succeed as an alternative to the courts. This demonstrated that in Kazakhstan the ability of firms to utilize the enforcement capabilities of the courts, i.e. the bailiff system, has proven to be of significant benefit in expanding the use of these institutions. This opens up space for a renewed discussion of legal supply (e.g. support for a more efficient bailiff system), when legal supply can be effective, and the relationship between increases in legal demand and the supply of law. Only by more fully understanding this relationship will it be possible for the technical assistance programs to be effective in supporting the development of courts and the rule of law in less developed countries.

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