

Industrial Defense Enterprises in the Russian Transition to a Capitalist System: Institutional Restrictions on Development

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Abstract: The author develops the concept of ‘clan capitalism’ that has emerged in Russia during a period of transition. Clan capitalism has led to certain institutional restrictions on business activity: informal rules becoming more important than formal norms, etc. As well as establishing the limits for growth; such restrictions also prevent the widespread uptake of effective business strategies. The author studied the consequences of clan capitalism in Russia; citing the case of the industrial defense enterprises and analyzing trends in their performance over the last decade through a longitudinal survey of top managers. This paper describes the current development in this sector as contradictory growth due to the lack of investment and innovation but caused by a rise in the state order. The author explains the peculiarities of this growth by illustrating restrictions within the system of clan capitalism.

Keywords: Russia, Transition, Clan capitalism, Institutional restriction on development, Industrial defense enterprise

JEL Classification Numbers: P26, P31

1. Objective

This paper focuses on examining systematic obstacles to Russian industrial development and cites the defense sector as an example. Under consideration are the features of economic institutions that have triggered widening decline in the industry, and prevent any growth potential.

The Russian transition to a capitalist society has encompassed a period of almost two decades. At the time of writing, we are now able to summarize the experience and draw an interim conclusion—namely what kind of post-transformation system has emerged, and which aspects of its performances restrict the nation’s industrial development.

As is common knowledge, certain major elements of the capitalist system became established during the transition period, such as private property, the freedom to create private companies, free trade and so on. Most Russians also gained some experience of operating within a market economy. Now, after the deep shock of such transformation, Russia has been enjoying economic growth since the crises of August 1998.

In the meantime, however, the majority of the public and the elite are unhappy about the socioeconomic system that has arisen following the transition. Some people call this system ‘criminal capitalism’, ‘robbery capitalism’, or ‘bureaucratic capitalism’. From my own perspective,

the most appropriate term is ‘clan capitalism’; which will be described later in further detail. Firstly, however, let us analyze the significant features of the Russian path to capitalism.

2. Features of the Russian path to capitalism

Countries in Eastern and Central Europe, where many historical prerequisites for the capitalist system applied, saw the birth of a ‘shock therapy’ strategy; developed by governments in collaboration with some consultants from advanced capitalist powers. Plans for reforms in China, meanwhile, (which possessed few preconditions for the capitalist system) were elaborated by leaders of the Communist Party, involving strict control of the political system and liberalizing the economy.

Although there were also certain prerequisites for the capitalist system in the USSR, the catalyst for the current Russian socioeconomic system was not a well-developed program of reform. Rather, the main feature of the ‘Russian way’ was the actual lack of any strategy to form the capitalist system advocated by the government in the early 1990s. In its place were numerous economic innovations, almost all of which were isolated, spontaneously implanted amid tough political clashes. Moreover, some innovations targeting a liberal economic system were implemented, rather than those which would lead to institutions for economic responsibility and a secure system of competition. In the meantime, the trajectory of the transition, the required stages and their order and duration, the role of the state and many other factors were uncontrolled. These specific aspects of the transition, aptly labeled transition ‘without a map’ by A. Schleifer and D. Treisman¹, triggered acute problems—decreased production, collapse in the living standards of many social groups, dramatic social inequality and a skyrocketing black economy and criminal underworld.

This Russian path of transformation combined liberal recipes alongside the preservation of certain Soviet socioeconomic institutions (numerous state subsidies for inefficient companies, conservation of many local monopolies, and so on.). Although economically speaking, it was very ineffective, it nevertheless provided relative social stability in a country with nuclear weapons.

The aforementioned path included the following three specific elements: 1) an initial liberalization thrust initiated by Gaidar’s team and rather akin to ‘shock therapy’, including privatization; 2) the retaining of many Soviet political, economic and social institutions; and 3) the creation of new institutions and business organizations following spontaneous social clashes where the victors were those with more social power, who was better organized, had access to government resources or governing experience and who could use the old system of informal social networks having emerged within the Soviet political system and shadow economy. The big victor was the part of old Soviet nomenklatura and this path was some sort of ‘third way’ between the Eastern/Central European and Chinese modes of transformation.²

At the time of writing, I can, however, conclude that as this specifically ‘Russian path’ has progressed; a relatively stable socioeconomic system has emerged.

3. Clan capitalism in Russia

Over the course of around two decades, an economic model known as ‘clan capitalism’ emerged in Russia during its transition to a capitalist system. The major features of this model are as follows.

Firstly, although the principal actors of the established system are socioeconomic clans, these do not include private business people in free competition among themselves. Rather, such clans are groups of business people, affiliated with state officials and sometimes organized criminal gangs, who exclusively control most profitable markets and shut out those who could produce cheaper goods of better quality.³ There are informal networks consolidating members of a certain clan headed by powerful leaders (such as Yeltsin, Putin, Luzhkov, Hodorkovski, and so on.). Such clans exist and operate at both federal and local levels, within various industries and many firms. They are the main sources of social initiative in the country, suppressing any interference from ‘non-clan’ activity, reducing the volume of resources in the hands of independent agents, removing officials and businesspeople, and clashing with the latter.

Another feature of this system is the relatively high level of economic freedom with a lack of rigid and precise legal regulations. As well as allowing powerful business clans to implement a wide range of economic activity, it also allows non-clan agents to pursue businesses in sectors that are of relatively little interest to the clans.

A significant feature of clan capitalism is the nomenclature business, which effectively eliminates rigid separation between the roles of businessman and officials. Many government officials directly and indirectly control private firms and share their profits. Hence, this model includes ‘cronyism’—special intimate links established between officials and certain businesspeople representing powerful clans.⁴

The next feature is that of post-Soviet monopolism, which is basically a non-market factor⁵ and which results from the functioning of the ‘clan structure’, rather than arising over the course of market competition. It is mainly fuelled by the state (both at federal and local levels) and criminal groups. State bodies (certain authorized officials) develop special activities to monopolize certain markets, for example, through a formal or informal ban on the activities of their competitors, and then enjoy monopolist positions in certain ‘crony’ firms, controlled by their relatives, friends or protégés. This situation is commonplace, for example, in many Russian regional vodka or gasoline markets.

Meanwhile, institutionalization of the widespread shadow economy is the essential feature of clan capitalism. Over the last three decades, the global shadow economy has been expanding in volume, and is now an established international phenomenon.⁶ Although the shadow portion of the economy amounts to around 25% overall in most countries with transitional economies, in Russia it reaches 35-40%, representing perhaps half of general economic activities; a level comparable to developing countries (in advanced OECD countries it averages only around 15%).⁷ Moreover, however, the shadow economy in Russia is not a marginal factor in the economic domain that only slightly impairs

the normal market mechanism. The reality is that the shadow economy operates throughout the entire Russian economy; penetrating the majority of Russian companies and firms to a greater or lesser degree. It is thus institutionalized now and has become an important element of business activity in Russia.⁸

As a core element of this system, clans in their current form emerged following public reaction to the hostile business climate in post-Soviet Russia. Businesspeople were—and still are—forced to secure themselves from attacks by bureaucrats wanting to take over businesses or from drives by criminals interested in taking control of their firms. It is easier for businesspeople to protect their business when part of a collective group; ‘cemented together’ by informal networks.

Clan capitalism is an integral system, and its all features are closely interconnected. Within the framework of the established clan capitalist system, there is political consensus between various forces interested in retaining the system. On the one hand, such consensus provides social stability in the short term but on the other, it represents one of the major obstacles to improving the economic system.

At the same time, Russian clan capitalism is also an inferior, stagnant market system, which has no mechanisms ensuring either economic responsibility (on the one hand) or development (on the other). Having specifically analyzed the distinctive elements of clan capitalism from other capitalist systems operating in the USA, Germany, Japan and Sweden, I can conclude that this model differs with regard to the principal actors and the level of economic freedom, as well as the role of the state in the economy.

As an inferior capitalist model, it triggers specific restrictions on economic development for business activity.

4. Institutional restrictions on business activity

Of these restrictions, the following five are the most significant.

The first is unprotected property rights for both the following reasons—i) the intervention of government and law enforcement officials in business, as well as criminal attacks by organized gangs; and ii) businesspeople included into informal networks within the clan, where despite the benefits afforded by patronage of this vast informal entity, they are forced to forgo their property rights to buy such protection. This is a sort of social contract—renunciation of economic sovereignty in exchange for security. As clan members, businesspeople are protected from hostile settings, but remain unable to invest money, innovate, sell their business or even hand it down without the informal permission of the clan leaders. Consequently, this leads to a lack of capital and of investment.

Another important institutional restriction is the inequality in market competition that results in a climate unfavorable for the growth of the most profitable businesses and in the preservation of ineffective companies. There is no incentive to innovate because of the many other ways to improve

the economic position of the firm. According to EBRD research in this area, Russia occupies one of the worst positions (15th) even among countries in transition (competitive situations were studied in 18 countries).⁹

The third restriction relates to the lack of transparency in the firms' operation. This is an essential feature, due to the informal networks encompassing such business activity. Managers and owners wish to hide their activities from tax authorities, other clan members and all other insiders and external persons. Such circumstances make it impossible to precisely calculate expenses and outcomes, which is a vital component of rational and effective economic behavior. Hence many projects, even those that are potentially highly profitable, remain on the drawing board.¹⁰

A further important restriction is the lack of trust in business connections, in the absence of any effective tools to force fulfillment of contracts outside a certain clan. Trust in business relations exists only within a certain clan, where business contacts among clan members can proceed with low transaction costs incurred. Conversely, inter-clan or clan-outsider relations conducted by individual businesspeople will incur far higher transaction costs, triggering an artificial decrease in the number of market actors; a factor that characterizes economic stagnation.¹¹

Finally, last but not least, informal rules are more important than formal norms because powerful clans can ignore almost every official law through channels of informal pressure. This causes permanent instability in business relations, in the economy and in society in general.

The above comprises the system of developmental restrictions—all of which are inter-connected. For example, the fact that informal rules take precedence over formal norms means that clans can ignore formal laws concerning the protection of property rights. In the meantime, this lack of protection for property rights triggers distrust in business connections, since unsecured businesspeople are wary of trusting anybody and fear losing their businesses through the unfair action of partners. Consequently, the clan capitalism system created a systematic obstacle to economic growth, meaning Russia cannot develop using its high potential.

Now, after an extended and collapsed period of stagnation, the country is once again enjoying economic growth. However, the inferior model of clan capitalism makes for rather contradictory development while retaining many painful and troublesome socioeconomic problems at the same time. Let us consider this further, citing the Russian defense sector as an example.

5. Contradictory development—the case of the defense sector

During the Soviet era, the defense sector was the most advanced industry sector, incorporating the highest level of national technology. It is therefore a good indicator of economic development; both in terms of utilizing the Soviet legacy and implementing technological capabilities.

The Russian defense sector currently consists of approximately 1,600 companies, comprising nearly 3 million employees (excluding the nuclear weapons sector). 42 percent of companies are

state owned; 33 percent are joint-stock companies with state sharing; and 25 percent are joint-stock companies without state sharing. In the early 90s, a cut of nearly two thirds in government procurements, the first step of radical market reforms, triggered a dramatic decrease in this sector. Accordingly, both production and employment plummeted. However, over the last 5 years, following the crisis of 1998, there has also been significant growth—more than 20% annually (of up to 33%). During this period, weapons exports have also increased and now amount to around 5 billion US\$ (mostly to India and China) each year.

To analyze the problem in detail, I will use data collected within a special longitudinal survey of the directors of defense companies, including 11 polls. These were carried out annually and bi-annually by a research group headed by Prof. R. Ryvkina and Dr. L. Kosals, of the Economic Sociology Laboratory in the Institute for Socioeconomic Problems of Population (Drs. Yu. Simagin, O. Kolennikova and Yu. Denisova comprise the research team). This study is carried out thanks to the organizational assistance of the League for the Support of Defense Enterprises.

The principal method is based on surveys of managers employed in the Russian defense sector in 1995-2003. Questionnaires were sent annually to more than 1,000 defense enterprises and addressed to their directors (CEOs). Each questionnaire, entitled ‘Military enterprise in transition to the market system’, included 70-100 questions aiming to reflect all major characteristics of the enterprise’s performance. The core questions were the same for all surveys, to allow changes to be monitored. The last poll was carried out in mid-2003¹² and the industrial structure of the sample reflected that in the defense sector in general (Table 1).

**Table 1 Industrial structure of defense sector
in general and in the sample, 2003**

Industries	In general		In sample	
	%	Rank	%	Rank
Aviation	17	3	21	2
Rockets and space	6	7	7	7
Electronics	18	2	16	3
Radio and liaison	25	1	24	1
Ship construction	13	4	10	5
Ammunition and special chemicals	11	5	13	4
Arms	10	6	9	6
Total	100		100	

Through the analysis of principal findings within this longitudinal study and on an ongoing basis, I will show that these figures indicate a contradictory development of the Russian defense sector. Let us consider five important points: 1) the problem of economic growth in the defense sector; 2)

technological change, 3) shifts in the structure of ownership; 4) criminal influence in this sector; and 5) directors' estimates as to the institutional status of their enterprises—whether they are capitalist firms or non-capitalist entities.

As in the previous period, 2003 saw continuous improvement in the position of the defense entities. This improvement was mentioned in 48% of the directors' answers, when estimating changes in the socioeconomic position of their companies over the past year; while 1/3 indicated an unchanged position and only 21% replied that it had worsened.

The same conclusion can be drawn through analysis of the increase and decrease in output within different enterprise groups (Table 2). In 2003 there was an 18% rise in output compared with 2002. Though this is less than that recorded in previous years after 1998, significant economic growth was apparent in more than 2/3 of the enterprises polled.

**Table 2 Director's estimates of the changes
in company production during 1995-2003 (%)**

Estimates of the changes in production	Years							
	1995	1996	1997	1998	1999	2000	2001	2003
Production was increased	9	15	33	26	81	81	77	70
Production was stable	77	42	34	30	5	14	13	17
Production was decreased	14	43	33	44	14	5	10	13
Total	100	100	100	100	100	100	100	100
Decrease (-) or increase (+) of the total production (%)	-20	-15	+5	-2	+63	+42	+23	+18
Official data	-20	-27	-16	-14	+33	+29	+15	+18*

* These data are concerning the first half of 2003 in compare with the first half of 2002
(Prime-TASS, 23.07.2003).

To answer these questions, I conducted a special analysis of the differences between growing and stagnant companies (where production remained stable or declined) to better understand the real socioeconomic results of the growth. In the meantime, comparative analysis of the growing and stagnant firms revealed contradictory economic growth (Table 3).

Regarding the entities in growth, although a higher proportion had invested than the stagnant ones (48% as opposed to 29%), the size of the investment was fourfold higher in stagnant firms than in growing (3.4m US\$ as opposed to 0.9m US\$ in 2003). Moreover, if we compare the size of investments needed for sustainable development, real investments were only 1.5% of the required level for growing companies and 17% for those stagnated, more than ten times higher.

Table 3 Socioeconomic differences between growing and stagnant companies in 2003

Enterprises	Percentage of companies making investments (%)	Size of investments (mln. US dollars)	Size of investments needed during the last 2-3 years (mln. US dollars)	Percentage of companies where state order was increased (%)	Percentage of new civilian goods in overall production (%)	Percentage of new military goods in overall production (%)	Percentage of companies with outdated technology (%)
Growing	48	0.9	63	51	38	28	54
Stagnant	29	3.4	18	26	31	17	46
In average	42	1.5	50	43	36	25	51
Difference is statistically significant (+)	+	+	-	+	-	-	-

Enterprises	Percentage of companies at the threshold of bankruptcy (%)	Balance of overdue debts (thousand rubles per 1 employee)	Percentage of exports in overall sales (%)	Size of enterprise (number of employees)	Average monthly wages (rubles)	Percentage of employees satisfied with labour relations (%)	Percentage of directors satisfied with their work (%)	Labour productivity of 1 employee (sales in thousand rubles per 1 employee)
Growing	20	-2.6	18	2,700	5,161	80	63	174
Stagnant	33	+9.1	19	1,882	4,729	54	66	189
In average	24	+1.1	18	2,454	5,032	72	63	178
Difference is statistically significant (+)	-	-	-	-	-	+	-	-

Likewise, although growing firms possessed a higher percentage of new goods in both civilian and military categories, a greater proportion of such firms had outdated technological structures compared to stagnant firms—54% for the former compared to 46% for the latter.

Thus the last five years revealed an upward trend in production at Russian defense enterprises. Since this is a significant trend, rather than any chance occurrence, we must examine the consequences of this growth, whether any restructuring took place at the enterprises concerned, the specific socioeconomic factors behind the growth and the nature of the perspectives for growing companies.

There are better social indicators within the growing enterprises (neither wages nor the percentage of employees satisfied with labor relations are statistically significant categories). Meanwhile, there is a reduced level of labor productivity and default on debts for growing companies—their balance of debts is negative, unlike stagnant firms.

Among the growing entities, the percentage of those on the threshold of bankruptcy is lower (although the difference is statistically insignificant). However, this group also includes a much higher share of those who benefited from the rise in state order. Obviously, this improves the likelihood of this group of enterprises improving their circumstances without market competition.

Analysis showed that the principal factor of the growth was the rise in state order (this order increased in 51% of growing firms as opposed to 26% of stagnant companies). This meant initial growth was provided by government subsidies rather than more efficient markets and intensive technological innovations. It aimed to reject current social troubles rather than trigger the deep economic restructuring necessary to create viable enterprises able to operate in the market without government support. It is true that the lack of restructuring was not solely down to a lack of will on the part of officials or managers—as S. Mizobata argues, Russian markets created specific contra-restructuring actors and behavior.¹³ Moreover, as suggested by our data concerning differences in investment activities, it seems that stagnant, rather than growing firms are entering phases of technological and managerial restructuring.

This means the current economic growth in the defense sector is the result of ‘corrosion’ of accumulated technological potential without restructuring.

Another negative indicator, signaling contradictory growth, is the fact that as they operate in the most advanced Russian industry sector, defense enterprises cannot function competitively in international markets. Indeed, only 17% of them are competitive entities oriented to international markets with 64% of sales in these markets (against an average sales figure of 18%). The majority of enterprises have outdated technologies and this percentage has been growing since the mid 90s (Table 4).

The percentage of firms with outdated technological structures rose almost two-fold, while that for those possessing particularly high technologies was insignificant.

**Table 4 Technological level of the Russian defense enterprises,
director's estimates in 1995-2003 (%)**

Technological level	1995	1996	1997	1998	1999	2000	2001	2002	2003
Competitive in the international market	9	8	5	3	3	2	2	2	2
Competitive only at the domestic level, but satisfactory	62	58	60	55	46	45	42	34	47
Outdated	29	34	35	42	51	53	56	64	51
Total	100	100	100	100	100	100	100	100	100

**Table 5 Structure of ownership in the non-government enterprises,
director's estimates in 1995-2003 (%)**

Owners	Years							
	1995	1996	1997	1998	1999	2000	2002	2003
State	24	20	21	15	19	18	21	17
Labour	47	37	38	37	37	38	22	20
Director	5	8	7	7	8	12	9	17
Investment funds	8	6	5	6	1	6	1	3
Other state enterprises	0	1	2	3	2	2	7	7
Other private enterprises	7	13	13	12	21	12	22	18
Foreigners	1	1	1	3	0	0	2	1
Banks	2	2	2	3	1	0	2	4
Individuals (Russian)	4	10	10	9	10	12	14	13
Others	2	2	1	5	1	0	0	0
Total	100	100	100	100	100	100	100	100

Analysis of the ownership structure shows this to be one of the factors behind the current stagnation. Although most defense enterprises were privatized (only 42% among them were fully state-owned), the real control over the property remains in the hands of insiders in most non-state enterprises: 37% of shares being owned by administration and labor (Table 5). Furthermore, the detailed structure of ownership is a shadow phenomenon in the case most companies, with the real proprietors often unknown. For example, although they may be unregistered, many directors are the shadow owners of the enterprises and the proportion of such 'shadow owners' of those directors polled was 15%. This ownership structure does not facilitate investment and represents unfavorable conditions for

development overall.

A significant part of the defense sector is under the control of criminal groups, with 22% of polled directors reporting criminal influence in their enterprises, and 10% stating their firms to be under the actual control of criminal groups. Taking into account the vastness of the Russian defense sector (around 1,600 companies with more than 2,000 employees in the average entity); this means that criminals are controlling military-industrial facilities larger than the defense sector of a mid-sized European country. Though the principal motive for criminal takeovers is economic (a desire to make money and take over valuable real estate, Table 6), it is a very dangerous situation in terms of international security, since some advanced arms could conceivably be accessible to international criminal groups and terrorist organizations.

Table 6 Why did criminal groups take over defense entities?
(directors' estimate, %*)

<u>They wanted them:</u>	
- for profits	82
- for taking over real estate	60
- to be looked as legal businesspeople	43
- to control Russian politics	30
- to control the Russian economy	28
- to penetrate into legal international markets of arm trade	14
- to control production of weapons, to accumulate an arsenal	11
- to penetrate into illegal international markets of arm trade	6

* Since every respondent could choose more than one answer, the total is not equal to 100%.

Finally, we cannot define regular Russian defense companies as classical capitalist enterprises aiming to gain profits, privately owned and operating within a market setting favorable for the accumulation of capital, providing long-term motivation to investments and innovation. The surveyed directors understand this situation, and 74% estimated their companies to be non-capitalist entities. We can instead define them as post-Soviet industrial enterprises with the potential to gradual evolution towards real capitalist firms if current institutional restrictions are eliminated. Economic, legal, political and ethical reforms are necessary to eliminate these restrictions. After two or three decades of reforms, existing post-Soviet business clans can be expected to carry out capitalist economic pursuits on the basis of a proper legal framework and social responsibility.

Notes

¹ See Shleifer and Treisman (2000).

² See an analysis of this path as the intermediate way between Eastern/Central European and Chinese path of transformation in Kosals (2000).

³ There are a few publications including analysis of the role of clans within modern economic systems; the majority of which are developed by management theorists (see Ouchi (2005), Alvesson and Lindkvist (1993), Boisot and Child (1996)); and certain related issues concerning post-Soviet countries (see Stark (1990), Dinello (2002), Kosals (1995)). However, most of these publications include analysis of certain evidence of clan activities which do not represent the core element of the specific capitalism model—namely, clan capitalism.

⁴ ‘Cronyism’ is one of the specific features of clan capitalism and described in detail within analysis of the latter that some researchers consider to be the specific model of capitalism developing in Latin America. See further details of crony capitalism, for example, in Haber (2002), Kang (2002), Shorrock (2002), and Krugman (2002).

⁵ Of course, monopolism exists as a legacy of the Soviet era, when, for example, only one plant for textiles was built within a big region, in accordance with a central economic plan. However, this is not an institutional feature of clan capitalism. Moreover, if Russia had a genuinely competitive market economy, such monopolism would be eliminated within a relatively short period.

⁶ As Enste and Schneider estimate, from the end of the 1980s to the mid-90s, the share of GDP of the shadow economy in East European countries increased by more than three per cent; in the former USSR, by almost 19%, and in OECD countries, by 4% (Enste and Schneider (1998)).

⁷ See Enste and Schneider (1998).

⁸ See details of the institutionalization of the Russian shadow economy in Kosals and Ryvkina (2001).

⁹ See Dutz and Vagliasindi (1999).

¹⁰ Some researchers outlined the non-transparency in the operation of the Russian firms due to their inclusion into informal business relations (Radaev (2003)).

¹¹ There are different responses of economic actors in the absence of trust—barter transactions, the building of special conventions, and so on. See Marin (2000), Radaev (2003).

¹² See Denisova *et al.* (2003).

¹³ See Mizobata (2002).

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