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The Invisible Hand and the Grabbing Hand

By TIMOTHY FRYE AND ANDREI SHLEIFER *

In the 1990's, several East European economies went through radical liberalization. Among them, Russia and Poland adopted similar packages of reforms, including almost complete price and trade liberalization, macroeconomic stabilization (which Poland accomplished five years before Russia), large-scale privatization (which Russia did four years before Poland), and small-scale privatization. While Poland started two years earlier, both reform packages were radical.

Despite the similarity of reform packages, the Polish economy responded much better to the treatment. By the mid-1990's, it was growing rapidly, while the Russian economy at best stopped shrinking. The formation and growth of small businesses was also more dramatic in Poland. According to the European Bank for Reconstruction and Development (EBRD, 1996), in 1995 Poland had about 2 million small private businesses, whereas Russia had only 1 million with a population almost four times larger. Even if we allow, as the EBRD does, that Russia had another 2 million unregistered private businesses, small-business formation is still more lethargic in Russia.

Why, despite similar reform packages, has the Russian entrepreneurial response been weaker? Using a pilot survey of shop managers conducted in Moscow and in Warsaw in the spring of 1996, we argue that a key reason for this outcome is there are very different relationships between government and business in the two countries. In the survey, we ask questions about the legal and regulatory environment in both cities. We find that the regulatory, and to some extent the legal,

environment is a good deal friendlier to business in Warsaw than in Moscow.

I. Government in Transition

There are three basic views of how bureaucrats and entrepreneurs interact during transition, as well as more generally. Under the *invisible-hand* model, the government is well-organized, generally uncorrupt, and relatively benevolent. It restricts itself to providing basic public goods, such as contract enforcement, law and order, and some regulations, and it leaves most allocative decisions to the private sector. Many countries in eastern Europe, particularly those hoping to join the European Community (Jeffrey Sachs, 1994), have looked to this model in their reforms.

In the two alternative models, government plays a larger role. Under the *helping-hand* model, commonly invoked in discussions of China (Andrew Walder, 1995), bureaucrats are intimately involved in promoting private economic activity: they support some firms and kill off others, pursue industrial policy, and often have close economic and family ties to entrepreneurs. The legal framework plays a limited role in this model, because bureaucrats adjudicate most disputes. Bureaucrats are corrupt, but corruption is relatively limited and organized. An extreme version of this model, the *iron-hand* model, is found in Southeast Asian countries like Korea and Singapore. In transition economies, however, the helping-hand model has been less prevalent.

In the final, *grabbing-hand*, model, government is just as interventionist, but much less organized, than in the helping-hand model. The government consists of a large number of substantially independent bureaucrats pursuing their own agendas, including taking bribes (see Shleifer and Robert Vishny, 1993). While these bureaucrats adopt the helping-hand rhetoric (Shleifer, 1996), in reality they are scarcely guided by a unified public-policy stance, and they remain largely independent of

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TABLE 1—ECONOMIC ROLE OF THE STATE DURING TRANSITION

Model	Legal environment	Regulatory environment
Invisible-hand	Government is not above law and uses power to supply minimal public goods. Courts enforce contracts.	Government follows rules. Regulation is minimal. Little corruption.
Helping-hand	Government is above law but uses power to help business. State officials enforce contracts.	Government aggressively regulates to promote some businesses. Organized corruption.
Grabbing-hand	Government is above law and uses power to extract rents. The legal system does not work. Mafia replaces state as enforcer.	Predatory regulations. Disorganized corruption.

courts, capable of imposing their will in commercial disputes, and empowered to impose on business a variety of predatory regulations. In the extreme cases, the government becomes sufficiently disorganized that it loses its ability to ensure law and order and to provide basic legal protections. As a consequence, contracts become privately enforced.

These three models of government are “ideal types,” and all real governments are mixtures of the three. Our questions try to assess how close local governments in Moscow and Warsaw are to these “ideal types” by focusing on the legal and regulatory environment. Table 1 summarizes the predictions of the three models of government that we examine.

II. The Survey

In March and April 1996, we surveyed 105 small shops: 55 in Moscow and 50 in Warsaw. We chose Moscow and Warsaw for two reasons. First, both Poland and Russia pursued

radical economic reforms. Second, private business in both countries is growing especially fast in the capitals, which also makes the comparison appropriate.

The shops were selected randomly from small-business directories (Business Karta Moskvi and Panorama Firmi) that include several thousand entries. The survey includes a mix of private and privatized retail shops, each with a staff of 5–50 employees. Most (62 percent) are food shops, but we also include barber shops, book stores, dry-cleaning establishments, and small department stores. On average, Moscow shops employ more workers than Warsaw shops (23.4 vs. 14.8, $t = 3.33$), which may be due to policies promoting very small businesses pursued by the Polish government. On average, Warsaw shops have been in operation for almost 4.5 years, and Moscow shops for 3.3 years ($t = -4.25$). This is consistent with Poland starting its transition almost two years before Russia. On average, Moscow shop managers are slightly older (44 vs. 42 years old, $t = 1.18$), have slightly more experience working in retail (16 vs. 14 years, $t = 0.98$), but slightly less experience as managers (8.7 vs. 10.5 years, $t = -1.02$) than their counterparts in Warsaw. Overall, we have broadly similar samples of shops in the two cities.

III. Results

Our questions on the legal environment address two issues: the effectiveness of court systems in dispute resolution and the role of protection rackets. Under the invisible-hand model, courts are effective in resolving disputes between private parties as well as between them and the government, and there is no room for protection rackets. Under the helping-hand model, courts play a smaller role, especially in disputes with the government, but the government is powerful enough to displace the rackets. Under the grabbing-hand model, government is ineffective in providing basic services, courts are ineffective in resolving disputes, and in the extreme, agreements are enforced privately. The questions in Table 2 look at these alternative predictions.

In both countries, courts are rarely used. Only 19 percent of shop managers in Moscow

and 14 percent in Warsaw reported using them in the previous two years ($t = 0.66$). This may simply reflect the high costs of using courts in both countries. However, when asked whether they needed to use the courts but did not, 45 percent of Moscow managers answered yes, whereas in Warsaw, only 10 percent did ($t = 4.32$). Either Moscow shop managers have less faith in their courts, or they face more disputes that potentially require court intervention than do their counterparts in Warsaw.

When asked whether they “could use courts to defend their rights if the government grossly violated their property rights,” 50 percent of Moscow respondents, and 41 percent of Warsaw respondents, answered yes ($t = 0.86$). Evidently, businesspeople in both countries have significant skepticism about the independence and effectiveness of courts in disputes with the government. On the other hand, when “the government” is replaced with “a business partner” in this question, 65 percent of the Moscow respondents, and only 38 percent of the Warsaw respondents, answer yes ($t = 1.97$). One interpretation of this finding is not the greater credibility of the Russian courts, but the greater availability of alternative means of dispute resolution in Warsaw. Finally, we find that 57 percent of the Moscow shops have hired legal counsel, compared to only 36 percent of Warsaw shops ($t = 2.2$). This may reflect greater interest in litigation, but more likely, lawyers are needed in Russia to deal with bureaucrats. Overall, we find a good deal of skepticism about the legal system in both countries.

We also ask about private rather than public protection. In Russia, shopowners often pay private security agencies to protect them from crime and to help resolve disputes. This institution is known as “a roof” in Russia, and “an umbrella” in Poland. We asked the respondents whether it is true that one cannot operate a store in their city without a roof (an umbrella). In Moscow, 76 percent answered yes, whereas in Poland only 6 percent did ($t = 10.10$). A related question is whether a shop manager has been contacted by the racket in the last six months. In Moscow, 39 percent of the respondents answered yes, whereas in Warsaw only 8 percent did. These data make clear that private enforcement of law and order

TABLE 2—LEGAL ENVIRONMENT

Question	Warsaw (<i>n</i>)	Moscow (<i>n</i>)	<i>t</i>
Used courts in the last 2 years?	0.14 (50)	0.19 (53)	0.66
Needed to use courts, but did not?	0.10 (50)	0.45 (53)	4.32
Can use courts against government?	0.41 (46)	0.50 (52)	0.86
Can use courts against business partner?	0.45 (38)	0.65 (52)	1.97
Contacted by racket in the last six months?	0.08 (50)	0.39 (54)	3.91
Does one need roof/umbrella to operate?	0.06 (50)	0.76 (54)	10.10

Notes: The table presents the fraction of affirmative responses to questions in Moscow and Warsaw and the *t* test of differences in responses.

plays a greater role in Russia than in Poland. Since the respondents in both cities are equally skeptical about courts, the likely reason for the higher incidence of protection rackets in Russia is the greater failure of simple police protection (order as opposed to law) in Russia.

The next set of questions deals with the regulatory environment, and the closely related problem of corruption (Table 3). We begin with a naive question about the helping-hand model. We ask, “Does the local government hinder, have no influence on, or help small business?” The answer is basically the same in the two cities: it has no influence. At least in their stance toward small business, both countries are very different from the East Asian model.

We then ask several regulatory questions. When asked how long it took to register their business, Moscow respondents reported an average of 2.7 months, compared to 0.7 months in Warsaw ($t = 5.02$). When asked how many inspections they had last year, Moscow managers reported an average of 18.56, and Warsaw managers 8.99 ($t = 3.46$). Moscow shop managers are also more likely to be fined by inspectors than their counterparts in Warsaw:

TABLE 3—REGULATORY ENVIRONMENT

Question	Warsaw (n)	Moscow (n)	t
Local government helps small business?	Hinders: 5 No influence: 41 Helps: 4 (50)	Hinders: 8 No influence: 39 Helps: 6 (53)	-0.19
Time to register business (months)?	0.72 (47)	2.71 (51)	5.02
Inspections last year?	9.0 (49)	18.56 (55)	3.46
Percentage of shops fined by inspectors last year?	46 (49)	83 (52)	2.72
Number of different agencies conducting inspections?	2.65 (49)	3.58 (55)	1.84
How legally vulnerable do you feel on scale of 1-10?	3.6 (50)	5.1 (55)	3.91
How often does one need to bribe officials on scale of 1-5?	2.21 (47)	2.9 (53)	2.52

Notes: The table presents responses to questions about government regulation and corruption and results of *t* tests of the difference between Warsaw and Moscow.

83 percent reported having paid fines compared to 46 percent in Warsaw ($t = 2.72$). Fines are likely to be a good measure of regulatory burden, as well as a proxy for corruption.

One measure of the severity of the regulatory burden is how concerned the shop managers are about being in violation of some regulations. To get at this issue, we ask shop managers how "legally vulnerable" they feel, on a scale from 1 to 10. The mean answer in Warsaw was 3.6, compared to 5.1 in Moscow ($t = 3.9$), consistent with the greater regulatory burden in Russia. Another measure of regulatory burden is corruption, since a standard way to get around the difficult regulations, requirements, delays, and fines is to pay a bribe. We ask our respondents somewhat discretely: how often does one need to bribe officials to do business in your city, on a scale from 1 to 5, (1, almost never; 2, rarely; 3, sometimes; 4, often; 5, almost always). The mean response in Warsaw was 2.2, compared to 2.9 in Moscow ($t = 2.52$). We also explore the structure

of corruption by asking how many different kinds of inspectors visited the shop. On average, 3.58 different agencies conducted inspections of Moscow shops, compared to 2.65 in Warsaw ($t = 1.84$). If we accept the Shleifer and Vishny (1993) view that the amount of bribes increases with the number of independent bribe-takers, this evidence points further to the greater burden of corruption and regulation in Moscow than in Warsaw.

In sum, our evidence indicates that shop-owners in neither country are particularly keen on using courts, though the Russian respondents have a greater need for them. On the other hand, private protection is used much more extensively in Russia than in Poland. Regulations in Russia appear to be a good deal more oppressive to business than they are in Poland. This is reflected in some measures of regulation, in the greater legal vulnerability that Russian respondents feel, and in the greater burden of corruption in Moscow.

The more predatory stance of Moscow's government toward business is consistent with the greater dynamism of such business in Warsaw. One further finding corroborates this view. When asked to rate the problem of product market competition on a scale from 1 to 10, Moscow shop managers' average answer was 4.8, compared to 6.2 in Warsaw ($t = 2.3$). Evidently, the Polish shopkeepers have their rents extracted by competitors, while the Russians have rents extracted by bureaucrats.

IV. Conclusion

We have presented some evidence from Moscow and Warsaw shops on their dealings with legal and regulatory institutions. While neither government is an "ideal type," the evidence points to the relatively greater relevance of the invisible-hand model to describe Poland, and of the grabbing-hand model to describe Russia. The law-enforcement and regulatory evidence in particular shows that Polish local governments are more supportive of business. This evidence is consistent with the greater energy shown by small business in Poland than in Russia despite similar economic reforms.

This conclusion suggests that, to understand transition experiences, it is not enough to know how much of a standard menu of radical

reforms a country adopts. The regulatory stance that national and local governments take toward business can perhaps explain as much as the package of reforms. This conclusion also raises a broader question: why do different governments follow such different models? We defer a discussion of this question to future work.

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