

Entrepreneurship in the Neo-Patrimonial State¹

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The (Neo-) Weberian conception of neo-patrimonialism was developed as an analytical tool for analyzing the political rule in post-colonial states. In short, neo-patrimonialism means the coincidence of a written rule of law and its arbitrary suspension within patron-client relationships. Recently, the conception has been updated and applied to the institutions of autocratic regimes, namely to post-communist countries. In contrast to early predictions of a gradual transformation to capitalism and democracy, many post-communist countries have settled in a hybrid system which permanently fall short of the rule of law but feature stability. The paper analyses how the political system subordinates the economy in order to create rents and maintain power. It is argued that the neo-patrimonial order should be interpreted as the institutionalization of uncertainty. The paper discusses a variety of entrepreneurial adjustments to the institutions of the neo-patrimonial order which form its economic development.

I. Introduction

The following paper deals with the operating principles of transition economies which restrain a competitive market order of the Western type of capitalism but defy a categorization within the “market order versus planned order” space. When the Soviet-type communist systems broke down and elected politicians started reforms in the former Soviet Union hemisphere, democracy and market order were widely considered as the ultimate arrival point for further development. Therefore, scholars were interested in the political system as to the achievement of democracy on the one hand and the market order including privatization and secure property rights on the other. Thereby the Western political and economic system defined the benchmark for the assessment of the intermediate result of progress.

In the meantime, after a transition period of 25 years, it turned out that it was premature to view capitalism and democracy as the ultimate goals of development. In contrast to the early EU accession countries such as Poland, the Czech Republic and Slovakia, which approach the standards of democracy and market based economy most closely, other former communist countries took a different route. EU accession (and now member) countries such as Bulgaria, Croatia or Hungary did not hinder the transition to authoritarian democracies, which constrain political competition and the development of a market economy alike, evoking complaints and

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infringement procedures by the EU. In other post-communist countries outside the EU such as Albania, Georgia, Ukraine, Russia, Belarus, Uzbekistan, Kazakhstan, Tadjikistan, blatant authoritarian orders have been established which deny basic standards of the rule of law. It seems overoptimistic to assess this development as a temporary setback from an overall and still intact institutional convergence process whose destination is defined by the Western coincidence of democracy and market economy. Rather, the “democratization bias” in early transformation research underwent a fundamental revision by recent political research (Timm, 2010; Hensell, 2009; Zimmer, 2005). Unlike earlier “big bang versus gradualism” controversies in the 1990s, current research focuses on the remarkable stability of authoritarian regimes, which appear to sustain even “color revolutions”, changes of political power at the head of the state notwithstanding (Stykow, 2010).

The former concentration on the liberalization of prices or public enterprises and other elements, which are important elements of ascertaining the degree of economic freedom, have given the impression that some of these post-communist countries are harboring institutions favorable to entrepreneurship and an emerging economy. For instance, the Fraser Index of Economic Freedom ranks Georgia as a “free country” and Albania and Montenegro as “partly free”.³ This is in sharp contrast to detailed studies of the political and economic systems of these countries, which describe them as prime examples of an arbitrary, authoritarian state in which entrepreneurs are subject to the discretion of authorities controlled by a highly corrupt and power-conscious, unscrupulous and sometimes even criminal elite group. These facts alone would qualify the countries under review as “unfree” if one considers the importance for economic freedom and entrepreneurship which liberals such as Friedman or Hayek attach to the rule of law (Friedman, 2002; Hayek, 1969).

In the following I want to dissolve this discrepancy in order to get an idea of the interaction of political and economic institutions which form the institutional environment in which entrepreneurship takes place. I follow recent research of New Institutional Economics which emphasizes the dependence of economic institutions on political power (Acemoglu/Robinson, 2012; North, Wallis and Weingast, 2009). Expanding on these theoretical conceptions, I put emphasis on the state and its authorities. As important as the question “who rules?” is, the subject of *how* the state wields power is equally critical. As we will see, (more or less) free elections are not necessarily a remedy against the arbitrary state; its operating principles can

³ See <https://www.fraserinstitute.org/uploadedFiles/fraser-ca/Content/research-news/research/publications/economic-freedom-of-the-world-2014.pdf>

sustain a change of power, leaving the institutions which constrain economic freedom unaffected.

As it turned out, notions such as “failed state” or “corruption” are less helpful to analyze the operating principles of this specific regime type and far less to understand its internal logic of executing power or commanding over economic resources. Rather, scholars have suggested that we conceive these states as rational political constructs, which satisfy the interests of the relevant agents (Christophe, 2005, 16). The denial of essential state functions such as the provision of public goods – which contributes to a high score of economic freedom in the Fraser Index – is reinterpreted as a cost-saving method of extracting resources and stabilizing the extant distribution of power, of which more later. By now, institutional scholars are still testing theoretical conceptions which are suitable for the understanding of this regime type. In order to get an idea of the political economy of the exercise of power in post-communist regimes, I apply the conception of “neo-patrimonialism” to which research increasingly refers (Albrecht/Frankenberger/Frech, 2011; Christophe, 2005; Hensell, 2009; Stefes, 2006; Timm, 2010, 2012; Zimmer, 2005).

Originally developed as a conception for post-colonial states, the Weberian conception has been adapted to post-communist countries. In a nutshell, it characterizes a social order in which the rule of law is not guaranteed and personal patron-client-relationships overlap and interfere with coexisting formal rights. While the institutional architecture of modern states – among them a parliament, presidential democracy, a written constitution, party competition, a Supreme Court and public administration – is formally mimicked, social relations within the public sector and between the public and the private sector, including the economy, largely depend on the discretionary and arbitrary use of political power. Strikingly, neo-patrimonial regimes established in those countries which failed to create a “rational legal authority” (Weber) before the communist period. This holds true for countries formerly ruled by the Tsarist and the Ottoman Empire. Here, patrimonial domination including personal despotism became also a distinguishing feature of communism; the large informal economic sector which by-passed central planning, namely in Romania, Bulgaria, and the Caucasian Soviet Republics of the USSR, became a by-product of patrimonial communism unknown in communist countries which had a tradition of legal authority. Neo-patrimonialism has survived after the breakdown of communism, which indicates a persistent institutional path-dependence.

In the following subsection, I link my analysis to Max Weber’s distinction of legal rationality and patrimonialism, which covers the spectrum for the new conception of neo-patrimonialism

(II). Then, I turn to the defining elements of neo-patrimonialism in post-communist countries, which have formed a specific regime type. Its characteristic is the institutionalization of uncertainty in order to preserve the extant regime and extract resources from the economy. Thereby, it forms a peculiar economic order unknown in Western economies (III). In the following subsection (IV), I analyze the resulting state-business relationships as a consequence of neo-patrimonialism and examine the ambiguous consequences for entrepreneurship. I give reasons why a competitive economic system comparable to Western capitalism can hardly be expected to emerge, which is why the term “transition economy” appears overoptimistic. In the final section (V), I derive some conclusions for entrepreneurial strategies to be expected and delineate corresponding hypotheses. The illustrations and examples in the paper seek to clarify structural similarities of neo-patrimonial orders in post-communist countries. As a disclaimer, it needs to be stressed that detailed case studies of particular countries which could provide further insights are beyond the scope of this paper.

II. The rule of law, legal rationality and patrimonialism

The institutional requirements of capitalism relevant for our argument are: The equality before the law, the security of property rights and independent courts which ensure individual autonomy including the freedom of contracting; these institutions deny preferential treatment of individuals or groups and thus are necessary requirements for the constitution of a competitive order (Hayek, 1969). As capitalism means self-coordination via contracts, an impersonal order which rests on enforceable contracts and the lawful disposal over property rights results. However, formal institutions laid down in the constitutions and the legal system do not suffice to guarantee the effective equality before the law. What matters is the application of legal norms by courts and public administration. Both requires the separation of powers as a necessary condition. As legal norms defy application by a formal algorithm but always entail an element of discretion (also in order to make further development of rules via refined application possible), the guiding principles of public administration become prominent. It was no coincidence that the development of modern capitalism in Europe was paralleled by the establishment of a legal bureaucracy which put the norms of equality before the law into practice and took shelter from arbitrary interference by political rule.⁴

⁴ In a profound study, Deecke (2015) takes the example of Prussia to analyze how public administration around 1800 started to promote capitalism by extending its influence vis-à-vis the monarch in order to abolish economic group privileges provided by the mercantile system.

Max Weber's analysis is credited for a coherent description of guidelines for public administration to be committed to legal norms (Weber, 1985, 124 – 130). Let us recall some of these principles because none of them are present in current neo-patrimonial states: Each public authority must have a well-defined sphere of competence which must not overlap with the ambits of other authorities; it operates independently from arbitrary interference of the ministry which can only influence its actions via regulations that apply generally; salary is the only form of income for civil servants; they are only committed to legal norms which cannot be overridden by their superiors; the appointment of civil servants requires formal qualification and results from an impartial recruitment process; the career depends on professional capacity, which implies that the positions of civil servants are largely unaffected by a change of political power; public administration operates in written form in order to keep its decisions reviewable.

The key problem for building public administration within the *Rechtsstaat* (a state committed to the rule-of-law) is that it must have a certain autonomy in which case the resulting flexibility in decision making must be aligned with the meaning and intention of legal norms. This requires additional safeguards, among them the coherence and consistency of legal norms in order to avoid trade-offs as far as possible; otherwise the scope of discretion for the application of norms widens. A further requirement, which is, however, difficult to operationalize, concerns the cost of complying with rules for its addressees. To give an example: When German (here: Prussian) authorities set up capitalist institutions in the first decades of the 19th century and preferred a moderate free trade regime to prohibitive custom duties, the cost of compliance played a major role in the debate; high tariff rates, the argument went, would raise compliance cost for enterprises and therefore incite circumvention (smuggling) and corruption of customs authority (which was a common practice in the preceding Napoleonic Continental System).⁵ When legal norms link to common sense, it becomes easier for authorities to demand that citizens comply with these rules that enjoy legitimacy as distinguished from legality.⁶ This view parallels North's claim that formal and informal institutions in society should accord with each other (North, 1990, 36 – 45).

Max Weber describes a type of public administration which developed in Western capitalism during the 19th century. At the same time, the process of democratization, which included a critical public, provided further safeguards for the rule of law to be applied by public administration. Thereby, the economic sphere became more and more disentangled from

⁵ See Wegner (2016a).

⁶ See Wegner (2016b).

political interferences and discretion or the benevolence of monarchs. This process of institutionalizing capitalism occurred in Western Europe during the 19th century; in Germany, for instance, the competitive market order (or “contract society” in terms of Max Weber) was completed in the mid 1860s. For every country, one milestone was the abolishment of guilds and the freedom of trade and industry; by and large, in any country the constitution of capitalism was finalized with the general permission of joint stock companies (1867 in Germany; 1844 in England; see Harris, 2000).

A similar development was absent in Southeast Europe, namely in the Tsarist and the Ottoman Empire. Patron-client-relationships and personal allegiance of subordinates figured prominently.⁷ The Tsar in Russia and the Sultan in Turkey were absolutist rulers who could appoint and dismiss officials at their sole discretion.⁸ Neither did an impersonal rule develop nor a public administration which could gain sufficient autonomy in order give strength to legal norms, to say nothing about the enforcement of legal norms towards the head of the state (Kischel, 2015, 586 – 590; Eich, 1984, 152). As regards Russia, Kischel’s comprehensive study of international comparative law coins the term “legal nihilism” rooted in the Tsarist order. (Kischel, 2015, 586). As one result of the absolutist order, which prevailed until the end of World War I, public administration could not make significant efforts to promote capitalist institutions nor did it adopt a progressive esprit de corps⁹. This differed significantly from European countries such as France or Prussia where the nobility established itself as a part of the corporate society. In both countries, progressive parts of the landed nobility could make use of their independent social status and encourage the ideals of enlightenment. In Prussia during the first half of the 19th century, leading figures of the nobility managed to establish a public administration aligned to legal rationality while ignoring complaints of their conservative peers against the “new impersonal order” (Harnisch, 1996); in France, progressive parts of the nobility even joined the French Revolution. By contrast, the absolutist orders of Russia, the Ottoman Empire but also the “Kingdom Dictatorships” in the Balkans did not evolve into an impersonal legal order which could have given birth to a sound civil society. Therefore, the traditional patrimonial society could not gradually transform itself into a viable liberal order.

⁷ See Eich (1984) for Russia and Wegner/Heinrich-Mechergui/Mechergui (2013) for the Ottoman Empire with emphasis on the Maghreb region.

⁸ In the colonized parts of the Ottoman Empire (Northern Africa, the Middle East) the central power was split and regional patrons (“Deys”) gained an independent role but established their own patrimonial systems.

⁹ This was the case in Prussia after the defeat in the war against Napoleon in 1806 when a group of open minded senior officials (backed by the monarch) instigated major reforms which launched a capitalist order (Wegner, 2016a).

This is one reason why radical political ideas – anarchism, communism, and diffuse combinations of both – gained ground against liberal political ideas.

Since proficiency did not rank high as a criterion for careers in public administration, civil servants sought to use their privileges for private purposes. Because of their uncertain professional status in the patrimonial order, it was not rational for them to develop a “public-interest” orientation or to pursue a progressive agenda for their territory. Rather, it was rational to exploit the providential status in order to accrue private benefits. Loyalty to the monarch and to local patrons who represented the monarch in the regions was key for personal success. The abuse of official positions for private purposes became institutionalized since the head of the state did not make efforts to mark out the ambits of authorities. The overlapping of competences was a deliberate instrument to neutralize civil servants and keep their professional ambitions at bay.

When the patrimonial orders broke down after WWI and gave way to socialist orders in most parts of Eastern Europe after WWII, public authorities advanced to a pillar of the state. Therefore, the introduction of public authorities necessary for a planned economy is sometimes interpreted as a push towards modernization. In the new society, economic plans overrode traditional elite privileges and the resulting patron-client-relationships. However, socialist bureaucracy differs from Weberian legal rational bureaucracy significantly (Hensell, 2009, 104): the former is committed to social and economic outcomes designed by the central plan while the latter secures legal norms for private actions with no regard of the social outcome; thereby it gives way to innovation competition and constitutes a “spontaneous order”. Furthermore, it turned out that in those countries which lacked a tradition of legal rationality, patrimonial social interactions survived in a changed form. Romania, Bulgaria or Yugoslavia (of which only a small part belonged to the Hungarian Crownlands of the Habsburg Empire) are examples for the prominent role of personal rule of socialist leaders, which put the “impersonal” communist ideology into place. Party leaders led a life of luxury, accumulated private wealth and appointed family members as officials, which came close to a new type of dynasty. Loyalty played a far greater role than ideological commitment or proficiency. As a by-product, the informal sector of the economy proliferated and offered many opportunities for additional income and the creation of personal dependencies besides the planned economy (Hensell, 2009, 105 – 116).

Both aspects were largely unknown in the GDR or the CSSR where the informal sector was deliberately kept down and a type of “patrimonial socialism” did not emerge. Here, material

privileges were moderate and officials viewed themselves much more as “servants of socialism” rather than as unconstrained exploiters of the state.¹⁰ Not accidentally, this alignment of the socialist elite group with the “impersonal”, abstract idea of communism apparently smoothed the way towards a liberal society after the break down of communism. By contrast, the apparently pragmatic combination of central planning and markets in patrimonial socialist orders (Caucasian Soviet republics, Yugoslavia, Bulgaria, Romania, Belarus, Russia with modifications) which was frequently assessed as a half-baked version of socialism turned out to be a much harder obstacle for capitalism and the rule of law. The heritage of patrimonialism in both forms, pre-socialist and socialist alike, was to form the transition process and the post-communist order to this day.

III. Constituent features of neo-patrimonialism

The conception of neo-patrimonialism was developed to analyze the functioning of post-colonial states and highlights the overlapping of formal legal norms with social patron–client interactions (Eisenstadt, 1973). Thereby, the type of patron-client-interaction undergoes a change and does not emanate from a traditional society e.g. between land-owners and peasants in the agricultural sector. Rather, the formal institutions of the modern state mold these interactions which are still dominated by the unequal access to resources. The monopoly of coercive power of the state rather than the inherited social status is utilized to attain, to corroborate and to defend the status of a patron. As an implication, neo-patrimonial orders require a certain level of development and cannot be settled in fragile orders commanded by chiefs or warlords. Depending on the assignation of political power in the respective regime, which spreads out a spectrum ranging from autocracy to a formal but constrained democracy with elections, the social equilibrium of patron-client-relations is more or less stable. This applies for multi-party neo-patrimonial orders in particular. The Ukraine after the rule of Kuchma and Serbia after Milosovic are representative for a multi-party version of neo-patrimonialism. The alignment with a formal democracy is revealing since it shifts our attention to the internal operation of the state rather than the form of government.¹¹ Nevertheless, I will also refer to more autocratic regimes which are also hosts of neo-patrimonialism.

¹⁰ For an overview of systemic corruption in the Soviet Union see Stefes (2006, 65 – 74).

¹¹ Although elections take place even in Russia or in Belarus, a change of power as a result of elections is impossible in these regimes.

In fact, a neo-patrimonial order can feature all relevant institutions of a parliamentary system. Despite attempts to discriminate against the political opposition, the latter can organize itself and has a chance to take over power after more or less free elections.¹² As a rule, constitutions bestow considerable power on the president who himself is elected by the people. Even in orders which are ranked as “not free” according to common indices, rulers lay stress on formal elections in order to confirm legitimacy. However, the formal institutions of a modern democracy including the separation of powers are blended with patrimonial social interactions. This interference must not be interpreted as a mere façade democratic system. Rather, the characteristic attribute is the unforeseeable “code switch” between norms of legal rationality and patrimonial interaction. Deliberate measures are taken to *institutionalize* uncertainty for the addressees of norms (see below).

Unlike traditional societies, and as a result of its democratic rudiments, the institutions of a neo-patrimonial order do not give the patron a guarantee of his status. Elections challenge his power. On the other hand, the political institutions of the modern state entail the advantage of the monopoly of coercive power and the instruments of the interventional state. It holds out a higher leverage for the ruler because he can dispose over taxes, market regulations, the public monopoly on money, public enterprises, and public agencies on his own behalf.

The constituent element of a neo-patrimonial order is the principal (“big man”) who organizes a client network.¹³ The common target of the members of this network and the *big man* is the appropriation of economic resources by use of the state, which requires the maintenance of the extant political power. Hence, both sides take advantage of the relation. Normally, the client networks rally support for political power of the patron but also for his economic resources; in exchange for its engagement it receives a share of the accumulated resources. The most prominent *big men* in the neo-patrimonial order are the president and the ministers whereby the varying access to power resources of the state determines their status in the hierarchy. Normally, the interior minister (who commands the police and the prisons) and the justice minister play the most prominent role; they organize client networks under their own control within their ministries. Typically, also on the local level politicians and principals of local authorities are the heads of their own client pyramids. Neo-patrimonial orders can differ with respect to the distribution of political power on the central and the local level. Stefes (2006) distinguishes

¹² According the Freedom-House-Index, most neo-patrimonial countries rank as partly free, Serbia even as free.

¹³ Here, I use the terms „principal“ and „patron“ synonymously.

neo-patrimonial orders of local and rather autonomous “big men” from centralized neo-patrimonial orders where local officials are agents of a one-headed neo-patrimonial hierarchy.¹⁴

The client network consists of civil servants which are co-opted and dismissed by the ministers; in many cases entrepreneurs without political ambition belong to the network. Since property rights are weak due to a lack of independent courts, and entrepreneurial success depends on the good will of politics in various ways, non-political entrepreneurs rarely form an independent power base which would qualify them as partners on par. Instead, they must seek access to the client network as well in order to take shelter from the arbitrary state. This can be profitable for both sides but will not give rise to a mercantile middle class independent from the state. Precarious in particular is the fact that a change of power can challenge entrepreneurial market success attained under the preceding government of political rivals.

Members of client networks within public administration are rarely co-opted as a result of proficiency. The hiring criterion is loyalty rather than qualification. Family members of loyal clients get preferential treatment in the recruitment process for valuable positions. The appointment of candidates without any qualification is a common practice as well as the sale of public offices.¹⁵ The discrepancy between low salaries and high prices for a public office, e.g. the police service, is striking and confirms that the purchase of offices can only be rational if access to corruption revenues offers a compensation (Christophe, 2005, 54); via “sharecropping” superior officers also benefit from the appointment. This practice attests to the fact that corruption is not the sum of individual infringements but reflects conformity to collective rules of the neo-patrimonial game.

Career progression follows similar principles of loyalty. Civil servants have little chances to prove their practical skills required for legal rationality and conformity to written rules. Their self-responsibility is constrained. Spheres of competences deliberately overlap and produce deadlocks which civil servants cannot dissolve within their own scope of decision making. This makes them – as well as the citizens or firms to whom legal norms apply – dependent on the goodwill of superior agents in order to offer a way out the bureaucratic impasse (see below). Besides, arbitrary interferences of the *big man* (minister) with daily issues is a common practice (Hensell, 2009, 139 - 144). Professional autonomy of the bureaucracy is not secured. As a consequence, civil servants have to take the interests of the patron into consideration and must dissociate from legal norms as the sole guideline for work behavior. This personal dependence

¹⁴ In the following, I refer to the centralized neo-patrimonial system because it comprises important elements which also work in its decentralized version.

¹⁵ See Hensell (2009, 151 and further literature) for the recruitment procedures in Albania.

is underscored by the lack of independent disciplinary courts, which is why subordinate civil servants are directly exposed to the sanctions of their patrons.

It is common to interpret corruption as individual behavior which weakens the power and the efficacy of the state (Hellman/Jones/Kaufmann, 2000). This holds true for states which have established the rule of law and legal rationality. In that interpretation, corruption is the individual infringement of predominant institutions. The opposite is true for the neo-patrimonial state. In this type of order, corruption has a systemic character which strengthens the power of the big men. Because salaries of civil servants are deliberately low, at least at the lower level of public administration, their susceptibility to “external” sources of income becomes part of the system. The dependency of subordinate civil servants on corruption payments is well-known and mostly tolerated by their patrons. However, since corruption is formally prohibited also in neo-patrimonial orders, patrons have an instrument of power over their clients and can control any attempts of emancipation (Timm, 2010). This reinforces the personal dependency of the clients on the benevolence of their patrons.

Ministers and local *big men* are themselves exposed to this insecurity which the head of the state purposely initializes. The generalization of corruption makes all members in the client network vulnerable to blackmail and anti-corruption campaigns, e.g. if the president seeks to keep political rivals at bay. Any anti-corruption campaign requires the formal existence and acceptance of legal norms corresponding to the rule of law. Therefore, rulers exhibit a certain interest to keep up codified legal norms. Without any idea of the rule of law, anti-corruption campaigns would be pointless. However, they do not represent the hopeful begin of a purification of the political system but just another instrument for the maintenance of the arbitrary state. It offers the chance to reproduce the regime in which the *big man* at the top level dismisses his rivals or disloyal members of his patronage network. The targets of anti-corruption campaigns are persons instead of institutions or social interactions. The persons to be sanctioned, in turn, are selected by the *big man*. If the prosecution of corruption would be initiated within the public prosecution office or from lower ranked civil servants, it would bear the risk of choosing “wrong targets”. Therefore, anti-corruption campaigns launched from above are likely to reproduce the neo-patrimonial order rather than establishing legal rationality as long as they do not end up with the reform of the public sector itself.

The precarious status of civil servants also results from the reshuffling of public administration after a change of political power. In the neo-patrimonial order, the state is captured by the winning party. Accordingly, a change of power will make for a replacement of positions in the

public sector. If the rival group wins, it will establish its own client network within the public administration. This confirms the suspicion that effective political competition that assigns power to changing majorities in parliament would not be a remedy for overcoming the neo-patrimonial order. As long as agents within public administration must be concerned about their positions resulting from elections, they will take up a short-term perspective and be attentive to their own benefits (Hensell, 2009, 180). They have no incentive to identify themselves with the “public interest” or the written rule of law because such a super-personal ideal lacks correspondence to individual interests in terms of professional advancement.¹⁶ Rather, they have a personal interest to use their positions to obstruct political competition and to hinder the political opposition.

As a preliminary result, we can distinguish neo-patrimonial orders from traditional patrimonialism with respect to the elite group, the role of the law and the implicit contract between the patron and its clients: Unlike patrimonialism where the elite group (e.g. the nobility) is entrenched in the traditional society and therefore enjoys a protected social status, neo-patrimonial orders appoint the members of the ruling elite group. Reportedly, skillful individuals from lower classes are promising new members of the client network because their engagement seems more reliable as a result of their social vulnerability. Their social status lacks protection from traditional rights but solely depends on the fulfillment of the implicit contract between them and the patron. If the client falls short of the behavioral expectations of the patron – e.g. because the patron expects greater contributions in terms of political support or lower claims to him – he can dismiss the client and (depending on the manifestation of human rights) even challenge his physical integrity. This dismissal, however, is executed by means of the law inasmuch as the patron can always claim an infringement of the law (e.g. tax laws, corruption laws, customs offences etc; see below). In neo-patrimonial orders the law gives the patron a powerful device to corroborate his power. The “rule-by-law” principle prevents the client from a legal defense against “unfair dismissal” if the claimed violation of the implicit contract, e.g. a breach of allegiance, seems unjustified for him. The arbitrariness to which he is exposed results from the peculiar role of the law.

Nevertheless, neo-patrimonial orders vary in this concern. The spectrum ranges from blatant ignorance of any public concern on the one hand to a mixed action orientation of agents on the other. This variation is useful to identify neo-patrimonial orders in more detail.

¹⁶ Bureaucrats in the Weberian sense have also private interests and motives. However, the pursuit of public interest and private career motives are in many ways mutually supportive.

IV. State-business relations within neo-patrimonialism

Nepotism and patronage are also real-world problems in advanced liberal orders of the Western world. In neo-patrimonial orders, however, they give rise to a specific type of capitalism which defies categorization within the “free market versus state-run economy”-space. In contrast to mixed economies of the Western type where the state redistributes, regulates and allocates resources for collective goods extensively, the arbitrary state changes the economic order far more dramatically. The outcomes are beneficial for the power holders and their networks in a way that reinforces the economic order rather than giving rise for a change of course.

Unlike mixed economies which redistribute income through the tax system or subsidies in a more rule-oriented way, the neo-patrimonial order exploits the state in a disorganized, personalized fashion; institutionalized uncertainty has a more fatal effect on private investment and competition. Through various regulations, the state offers and restricts economic opportunities, e.g. production possibilities, trade opportunities, access to loans and preferential treatment for economic opportunities in the criminal sector. Building licenses, licenses for importing goods and export guarantees but also arbitrary taxation and the imposition of duties are privileged tools for the state in order to generate incomes. Among the several options for agents in the public administration (including *big men*) are the following: (1) Using the sanction potential of their positions to extract resources from the private sector; (2) starting oneself a business and protecting it against competition by use of legislation and regulation; (3) leasing market access rights to outsiders against payments; (4) pressing firms to finance election campaigns in order to stay in power; (5) tolerating illegal (including criminal) activities of outsiders against payments or political support; (6) extending the field of illegality via overregulation, which strengthens the dependency of firms on public administration and law enforcement agencies; (7) lining tax revenues into their own pockets while reducing expenditures for public goods; (8) “privatizing” parts of the profitable public sector industries for family members; (9) repressing prospering firms in order to initiate their sale to cronies; (10) blatant confiscation under the pretext of illegal behavior of the company management.

The more “active” variant of rent creation is state-centered entrepreneurship. The “privatization” of public services, particularly the telecommunication sector, electricity, transportation facilities (airports, harbors) or associated industries offer gains from monopoly. In some cases, *big men* also seize the tourist sector. Obligatory insurances, e.g. liability insurances for car drivers, can be monopolized and assigned to patrons or to their relatives

(Hensell, 2009, 193). If the neo-patrimonial state disposes over natural resources, income possibilities can reach fabulous dimensions unknown to democratically elected politicians in modern democracies. In smaller countries, the entanglement of the state with the economy offers attractive opportunities for economic activities originating from public administration. Key for entrepreneurial success is the political prevention of economic competitors and the stability of patron-client-networks. Competitors outside the client network are to be excluded from market entry, which protects the monopoly for the insiders.

Lower-ranked members of the client network who become successful entrepreneurs must be kept under control in order to preserve the hierarchy between patrons and clients. Otherwise, an internal fight for claims would break out which could destabilize the entire neo-patrimonial order. The Russian billionaire Vladimir Yevtushenko puts it like this:

In our society, ..., the size of a business has to correspond to the political influence of its owners. If the size of a business corresponds to the political influence, the owners can be sure about their business, because they have the resources and energy to defend it. If the size of a business significantly exceeds the political influence of the owners, it is very hard for them to hold on to it.' (*Vladimir Yevtushenkov o Mikhaile Khodorkovskom* 2012)¹⁷

One instrument to keep the economy in line with the political hierarchy is the leasing of market access rights which the patrons can discontinue if the clients become too powerful. This sanction can be leveraged by threatening repression including imprisonment to achievers within the network. Of most importance is the impediment of ambitious companies outside the client network without political protection. Not only would such competition threaten the economic assets accumulated within the network; it would also dispute the neo-patrimonial order altogether since investments of the clients into the order could become worthless. A countervailing power, which disposes over resources independent from the client network, would challenge the entire social order. Therefore, keeping the economy under control of the patronage network is a requirement to uphold the social hierarchy.

The instruments of power are the specific adaptation of legislation to the arbitrary state and the law enforcement agencies. Both are suitable instruments to preserve monopolies held by the *big men* and the clients but offer also manifold opportunities for extracting resources from so far tolerated firms outside the network. A proper strategy for legislation in the neo-patrimonial state is the passage of complex laws which are intransparent and contradictory. As a result, compliance becomes impossible for law-abiding citizens and corporations. This equips civil servants with the chance to tolerate the violation of the law or to dissolve bureaucratic blockages

¹⁷ See Kluge (2015, 13)

against payments or participations in the enterprises (Hensell, 2009, 168). Timm (2010) highlights the creativity of legislators in the neo-patrimonial state in order to establish contradictory regulations.¹⁸ In Russian language a new term has been coined which points to the amount of potential bribes that civil servants can extract from the violation of contradictory and deliberately complex laws (“vzjatkoemkost”; Timm, 2010, 112).

In an informed case study including interviews with local big men in Georgia, Christophe (2005) gives illustration how the system worked. The owner of big department store in an attractive location was charged for violating sanitary and safety regulations until he was willing to sell his shop to a relative of the local *big man*. Nazrullaeva, Baranov and Yakovlev (2013) give a further example of a big bakery which used poppy seed and was accused of violating drug laws. During the dispute, the minimum level for poppy opiate was repeatedly altered in order to maintain the menace. A scientist who disburdened the entrepreneur on the base of a report was temporarily arrested. A similar cases is quoted from Nazrullaeva, Baranov and Yakovlev (2013):

Another common scheme is the accusation of improper use of subsidized government bank loan. In 2008 a successful dairy businessman, Dmitry Malov from Kostroma (a city 300 km away from Moscow), was visited by two former officers of Economic department of MVD. The visitors urged him to sell his enterprise to an unknown person. After his refusal they menaced with litigation. Afterwards Mr. Malov was charged with fraud. He proceeded against the accusation and the court proceedings was dropped. But eventually the FSB office in Kostroma reopened the case. Despite absence of complaints from the creditor, timely payments of debt, and using the loan on stipulated purposes he was accused of improper use of investment credit. Mr. Malov believes that he was “commissioned”, i.e. someone involved in property development might have paid officers, as his company’s factory is situated in the city center which makes this plot quite attractive. In 2010 Mr. Malov was sentenced to 5.5 years in prison, and spent in jail almost 2 years. (Nazrullaeva, Baranov, Yakovlev, 2013, 11)

Case studies give many accounts of this type although a quantification is difficult.¹⁹ In all cases, the arbitrary use of legislation and regulation institutionalizes uncertainty for entrepreneurs and individuals. Members of the client network themselves are exposed to this uncertainty when the government changes and a new network seizes power; revenge for former unfair treatment is a reported reaction. The key power strategy of the “rule-by-law” system is to produce unlawful firms and citizens so that public administration can apply pressure to them at any time. They cannot be sure when and to what extent the unavoidable violation of rules is tolerated or sanctioned.

¹⁸ See also Stefes (2006, 23) who gives further references.

¹⁹ Systematic studies such as Hensell (2009) and Christophe (2005) are based on interviews with officials and entrepreneurs which give a meticulous picture of the nature of the arbitrary state; of course, the interview partners conceal information about current figures and accrued corruption payments or the numbers of “victims”.

Extraction of payments will not follow rational economic calculation which maximizes long term payments and weighs the increase of payments against the decline of resources resulting from the disincentive of extortion. First of all, there is the obvious option to take over the assets in case of default of payments, which is why public administration has little incentives to preserve private property as an overall guideline. Secondly, and of equal importance, the agents within public administration themselves lack security. Once they have invested in their positions through payments, they are uncertain about the durability of their status in view of potential changes of power. Given this lack of certainty, they are interested in having a return on investment in the short term. Public administration in the neo-patrimonial system will hardly form a long term interest and will not adopt an overall economic perspective of their country as has been documented for public administration in the Western capitalist transformation process. The institutional environment, of which they are part, incites short term utility maximization.

This is reinforced by the way how the neo-patrimonial system handles corruption. As it is generally practiced, all civil servants are potential victims of anti-corruption campaigns and dependent on the generosity of their patrons (see above). Therefore, patrons can “individualize” the phenomenon and dismiss unwanted subordinates. For instance, when extortion revenues to be shared with superiors fall short of expectation, superiors can take this as an opportunity to appoint civil servants they expect to be more “efficient”. Thereby, superiors can switch the code from legal norms that prohibit corruption to patrimonial dependency and vice versa (Timm, 2010). In this way, uncertainty is institutionalized for officials as well. Therefore, clients within public administrations are well advised to take up a short term perspectives on extortions while ignoring the long term consequences on the state of the economy. It is not rational to adopt a “public-interest” perspective on the economy.

The same holds true for entrepreneurs. In transformation processes of Western economies, the bourgeoisie often took up a progressive role and promoted institutions which separated the economy from the state via independent civil courts or a public administration which committed itself to the rule of law. For instance, the capitalist transformation process in the German states during the 19th century witnessed continuing efforts of disentangling the economy from state interventions and regulations; this process ended up in competitive capitalism in the second half

of the 19th century²⁰. By contrast, in the neo-patrimonial state it is questionable whether entrepreneurs are able to make a similar coordinated action. Unlike neo-patrimonial states, capitalists in Western economies are not involved in the authorities of the state which is why they can form a collective interest towards private autonomy. In the neo-patrimonial state, the most successful entrepreneurs are those who benefit from a system which constrains competition and “creative destruction”. There will always be outsiders who suffer from the arbitrary state but it remains open whether they could form a critical mass in order to transform their discontent into according collective action against arbitrary public administration. By contrast, entrepreneurs who own monopolies protected by the patronage network as well as clients within administration profit from neo-patrimonialism. They have to lose much from institutions committed to the rule-of-law and capitalist institutions; accordingly they will not have a natural interest in establishing the rule of law but are natural allies of the prevailing order.

Nevertheless, under certain circumstances the neo-patrimonial order can fail to integrate capitalist entrepreneurs into the system. When businesses growth outside the patronage network is ample and reaches a critical mass, collective actions of capitalists against the arbitrary state and on behalf the rule-of-law becomes more likely. Yakovlev (2013) depicts such developments in Russia from 2000 to 2006. Small and medium sized enterprises organized themselves in two organizations and canvassed support for a change of state-business relations. Effectively, violent pressure on business men decreased, the tax system became simplified and pre-trial arrestments reduced. However, the “siloviki” (*big men* within public administration coming from the secret service FSB) took the “Yukos” affair, which led to the arbitrary arrestment of Chodorkovski, a leading oligarch with political ambitions, as an opportunity to bring the reform to a halt. Later on, the interests within the neo-patrimonial order were inconsistent and left the political order in a stuck state. The continuous repression of civil rights reversed the former changes. Now it has become clear that collective action of business organizations in favor of improvements of the legal system depended on the freedom of speech, press and the internet. In the absence of civil rights entrepreneurial collective actions proved futile.

The case of Russia is noteworthy for at least two reasons: First of all, in a larger economy having experienced economic growth, the economy can become sufficiently differentiated; if

²⁰ In the 1860s, the bourgeoisie in Prussia and (after 1867) made coordinated political efforts to establish a free market economy; the according institutions had been taken over into Imperial Germany after 1871; see Boch (2007).

parts of the economy escape control of the public sector, and become successful without patronage, entrepreneurial interests start to differ from those within the patronage network. Secondly, alongside the vertical power line, interests can lose consistency. In order to keep political rivals at bay, the patron on the head of the state may himself be interested in economic development. Thereby, his political interests start to conflict with the “siloviki” (in case of Russia). On the other hand, the political leader still depends on loyalty of his clients who are interested in the extraction of resources and local power based on arbitrariness. A pull test of the order is likely but the outcome is unpredictable, far more the outlook for a sustainable increase in the rule of law.²¹

V. Consequences for entrepreneurship

Given the institutional environment described above, economic opportunities in the neo-patrimonial state can be outstanding. The combination of the monopoly of coercive power of the state, its arbitrary use and the existence of “free” markets offer great chances as long as entrepreneurs are themselves patrons or enjoy the status of loyal clients. Especially in those poor neo-patrimonial states which come close to autocracies, the running transition to the illegal sector gives access to significant resources. This reinforces efforts within the network to uphold the order. Case studies of neo-patrimonial order report the enormous economic incentive for politicians to keep on with the hierarchy. For instance, in Albania as well as in Georgia highest government circles became rich because they were involved in the illegal transport of refugees, drugs, weapons, workers and women (for prostitution).²² As far as the legal sector of the economy is concerned, the neo-patrimonial order is characterized by durable monopolies which cannot be contested by outsiders of the political system. This gives strong incentives for entrepreneurs to become part of the patronage network or at least to support the system. As personal connections are the glue of the system, the formation of family ties, e.g. via marrying family members, is a useful method. A common practice is also the support of election campaigns or the financing of public goods (including the rudimentary welfare system) in order to increase the public reputation of the patron. Such side-payments constitute the unofficial part

²¹ When the President Putin came under pressure of economic sanctions applied by Western countries after the conflict in the Ukraine, he passed laws (in 2014) which exempted Russian firms from screening processes of public administration and leaved aside the economic interests of agents in bureaucracy. This action can be seen as a helpless compromise between improvement of the rule of law and consideration of the interest of the dominant coalition.

²² See Hensell (2009, 182 – 192).

of corporate taxation by which entrepreneurs try to stabilize their institutional environment. Such payments are rental charges for market access and, depending on the degree of arbitrariness, charges for the security of property rights, sometimes also for personal freedom.

The most progressive strategy aiming at overcoming the order would be the forming of business organizations outside the client network in order to promote the rule of law. This strategy is worth considering in more advanced economies which are too big for being fully subordinated to the neo-patrimonial order. Organizing collective actions against the client network is nevertheless a risky strategy whose success depends on many conditions. Among them is the existence of a critical mass of entrepreneurial outsiders who have coherent interests, which implies that they do not see a reasonable chance of integrating themselves into the client network. This strategy could link to the pretended claim of neo-patrimonial orders to pursue the rule of law, notwithstanding its arbitrary suspension by patrons. Furthermore, if the legal system indicates promising steps to emancipate itself from political interference, business organizations can avail themselves of these efforts and expand on the territory of legal norms. However, such a strategy needs backing by the head of the state in order to become successful against opponents within the network. To the extent that the legitimacy of the rule depends on sustaining economic development, the interest of the head of the state diverges from its lower-ranked clients within public administration and business cronies.²³

The complete emancipation of the economy from the state, however, faces the problem that key actors of the neo-patrimonial order are alert to the consequences of untrammelled competition, which undermines their opportunities for rent extraction; capitalist institutions, once established, will fail to offer similar opportunities for such preferential treatment (Yakovlev, 2013). Therefore, especially in smaller economies, political agents reportedly stifle the emergence of an independent economy that could challenge the patronage network. As a result, large firms which have grown independently from political protection are under permanent control; they are viewed as a potential threat for the extant order and potential targets for extortion (Kluge, 2015).

A proven entrepreneurial response is a “small but free”-strategy. In so doing, firms escape attention from the patronage network and could pass for petty entrepreneurs; they avoid

²³ Yakovlev (2013) describes promising developments in Russia in a small period of time before the Yukov-affair; at that time business organizations successfully promoted the rule of law and were backed president Putin until the corrupt administration gained ground in order to keep rivals at bay.

becoming an attractive prey for the agents of the arbitrary state. Business growth beyond a threshold level always entails the risk that firms come on the screen of public administration which discovers an opportunity of expropriation. It is also a collectively rational strategy since prolific petty entrepreneurship will not be seen as a challenge for the political order. By this, entrepreneurs come to terms with the neo-patrimonial order while assuring their smaller profits. A lot of anecdotal evidence for this phenomenon exists which presumably can only be recorded by interviews.²⁴

A further strategy is the lowering of market exit costs in order to be armed against offenses from public administration. Investments in manufacturing industry are preferred targets for extortion since firms depend in various ways on administration (infrastructure, electricity, licenses). Reportedly, Russian public administration requires new licenses from firms if they make only minor changes to their production portfolio (Yakovlev, 2013). Not accidentally, manufacturing industries in neo-patrimonial systems are preferably run by foreign investors who have better chances to protect their investment through political support; in addition they can often take resort to committees for foreign economic relations or have direct access to the president.²⁵ By contrast, local entrepreneurs experience far greater discrimination and consequently avoid investment where property rights are extremely uncertain.

Accordingly, the hypothesis ensues that local entrepreneurs will disproportionately invest in the service sector and parts of the IT-sector (preferably software industry) where market exit costs are significantly lower than in the manufacturing industry. In these sectors, entrepreneurs do not have to invest in large plants which depend on public utilities and give local administration a leverage against them. Even if the government seeks to further private investment in the industry, rational domestic entrepreneurs will anticipate the hold-up problem arising from their specific capital investment. In the absence of a credible third-party enforcement which could commit public administration to legal norms, start-up entrepreneurs will look for activities which provide more independence from arbitrary regulators. The

²⁴ For Tunisia under the rule of Ben Ali, Wegner/Heinrich-Mechergui/Mechergui (2013) report that entrepreneurs outside Ben Ali's cronies took resort to this avoidance strategies. This is also to be expected in post-Soviet neo-patrimonial orders.

²⁵ For instance, German investors in Hungary are reportedly unconcerned about recent attempts of President Orbán to bring the economy under his control; instead they are pointing to their close personal connections to him. However, as Kluge (2015) points out, the status of a foreign investor does not protect against arbitrary offenses; in his case, Russian regulators withdrew licenses from the Swedish telecommunication company Tele2 under the pretext of a violation of regulation. The only preferential treatment of the foreign investor was that the CEO was not arrested but urged to sell the company to a Russian firm belonging to the client network.

prospering software industry in Russia and the underinvestment in manufacturing (despite considerable demand excess, namely after the devaluation of the Russian currency and the export bans from Western economies) give evidence that entrepreneurial efforts do not correspond to relative prices and scarcity. They do correspond to comparative institutional disadvantages and the distorted incentives within the neo-patrimonial order.²⁶ Therefore, a booming software industry must not be interpreted as a push for modernization in the economy. In view of relative prices investment in the manufacturing sector would have had priority but domestic investors outside the patronage network will not bear the political risk. Besides, the patronage network will control the access to bank loans and exclude outsiders. Under these circumstances, foreign direct investment will dominate the manufacturing sector and enjoy a certain (but not perfect) protection from expropriation. As an empirical hypothesis which derives from this one would expect that neo-patrimonial orders will exhibit an overinvestment in the IT-sector but an underinvestment in the industry and manufactories.

To conclude, entrepreneurial strategies fall into four categories: (1) Integrating oneself into the neo-patrimonial order; (2) Collective actions in order to soften its negative effect and gradually transform the order; (3) Avoidance strategies in order to escape the scope and control of the neo-patrimonial order; (4) Shifting entrepreneurial efforts to activities with low market exit costs.

The first strategy faces limitations since the continuing integration of entrepreneurs will dissipate the rents extractable from the neo-patrimonial order. It is only feasible as an individual strategy rather than a collective strategy in a growing economy. The second strategy is important to record because it indicates attempts for establishing rule of law for a specific group in society. North/Wallis/Weingast (2009) interpret such a change as the beginning of an erosion of so-called Limited Access Orders; at best it could be an indication of emerging capitalism from below. A change of procedure rules for public administration and the legal system is helpful to assess whether the neo-patrimonial order is under erosion. This would also put a too pessimistic view on neo-patrimonialism into perspective. Scholars who have revitalized this concept with application to post-socialist countries emphasize the long-term stability of the neo-patrimonial order. Accordingly it is argued that a change of political power, e.g. by a “color revolution” would reproduce the regime, given the high incentives for the new power holders to gain from their new positions (Stykow, 2010). The establishment of the rule of law would

²⁶ For the conception of comparative institutional advantage see Hall/Soskice (2001).

entail high opportunity cost for new power holders because they would be the first to do without the economic advantages of neo-patrimonialism. However, if entrepreneurs adopt and amplify strategy (2), their behavior indicates the undermining of the system “from below” and challenge the hypothesis of stable neo-patrimonial orders²⁷. However, avoidance strategies including the strategy of lowering market exit-costs have a low risk profile for entrepreneurs in the neo-patrimonial order. We expect that they will be the more likely options for entrepreneurs and support the continuity hypothesis concerning neo-patrimonialism. For further analysis and namely for case studies it would be informative to identify avoidance strategies corresponding to comparative institutional disadvantages in more detail because they will form the long-term path of economic development.

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²⁷ See Stykow (2010) who claims that “color revolutions” tend to reproduce the autocratic order.

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