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THE INVISIBLE HAND AND THE  
GRABBING HAND

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**ABSTRACT**

Evidence from a survey of 105 shop-owners in Moscow and Warsaw shows that the reliance on private protection, as well as the burden of regulation and corruption, are much greater in Moscow. The evidence suggests that the “invisible hand” model of government better fits the Warsaw local government, and the “grabbing hand” model is more appropriate for Moscow. The evidence implies that the singular focus on the speed of economic reforms to understand the success of transition is misplaced, and that the quality of government may be as essential.

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In the 1990s, 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 did 5 years before Russia), large scale privatization (which Russia did 4 years before Poland), and small scale privatization. While Poland started 2 years earlier, both reform packages were radical.

Despite the similarity of reform packages, the Polish economy responded much better to the treatment. By mid-1990s, 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 EBRD (1996), in 1995 Poland had about 2 million small private businesses, whereas Russia had only 1 million with a population almost 4 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 the 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.

#### 1. 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 leaves most allocative decisions to the private sector. Many countries in Eastern Europe -- particularly those hoping to join the European Community (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 (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 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 remain largely independent of 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.

## 2. 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 are selected randomly from small business directories (Business Karta Moskvi and Panorama Firmi, respectively) that include several thousand entries. The survey includes a mix of private and privatized retail shops with a staff of 5-50 employees. Most (62%) are food shops, but we also include barber shops, book stores, dry cleaning, and small department stores. On average, Moscow shops employ slightly 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,  $t=.98$ ), 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.

## 3. Results.

Our questions on 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 report using them in the last 2 years ( $t = .66$ ). This may simply reflect the high costs of using courts in both countries. However, when asked whether they needed to use the courts but didn't, 45 percent of Moscow managers answer yes, whereas in Warsaw, only 10 percent do ( $t = 4.32$ ). Either Moscow shop managers have less faith in their courts, or they face more disputes that potentially require court intervention than 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, answer "yes" ( $t = .86$ ). Evidently, business people 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 ask the respondents whether it is true that one cannot operate a store in your city without a roof (an umbrella). In Moscow, 76 percent answer “yes”, whereas in Poland only 6 percent do ( $t = 10.10$ ). A related question is whether a shop manager has been contacted by the racket in the last 6 months. In Moscow, 39 percent of the respondents answer “yes,” whereas in Warsaw only 8 percent do. These data make clear that private enforcement of law and order 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 the respondents “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 average 2.7 months, compared to .7 months in Warsaw ( $t = 5.02$ ). When asked how many inspections they had last year, Moscow managers average 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: 83 percent of them report 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 is 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 is almost never, 2 is rarely, 3 is sometimes, 4 is often, and 5 is almost always). The mean response in Warsaw is 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 shopowners 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 regulations, in greater legal vulnerability that Russian respondents feel, as well as 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 is 4.8, compared to 6.2 in Warsaw ( $t=2.3$ ). Evidently, the Polish shopkeepers have their rents extracted by competitors, while the Russian ones by bureaucrats.

#### 4. 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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**Table 1: Economic Role of the State During Transition**

	<b>Legal Environment</b>	<b>Regulatory Environment</b>
<b>Invisible Hand</b>	Government is not above law and uses power to supply minimal public goods. Courts enforce contracts.	Government follows rules. Regulation is minimal. Little corruption.
<b>Helping Hand</b>	Government is above law, but uses power to help business. State officials enforce contracts.	Government aggressively regulates to promote some businesses. Organized corruption.
<b>Grabbing Hand</b>	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.

**Table 2: Legal Environment**

This table presents the fraction of affirmative responses to questions in Moscow and Warsaw and the T-test of differences in responses.

	<b>Warsaw (n)</b>	<b>Moscow (n)</b>	<b>T statistic</b>
<b>Used courts in the last 2 years.</b>	.14 (50)	.19 (53)	.66
<b>Needed to use courts, but did not.</b>	.10 (50)	.45 (53)	4.32
<b>Can use courts against government.</b>	.41 (46)	.50 (52)	.86
<b>Can use courts against business partner.</b>	.45 (38)	.65 (52)	1.97
<b>Contacted by racket in the last 6 months.</b>	.08 (50)	.39 (54)	3.91
<b>Does one need roof/umbrella to operate.</b>	.06 (50)	.76 (54)	10.10

**Table 3: Regulatory Environment**

The table presents responses to questions about government regulation and corruption and tests of difference between Warsaw and Moscow.

	<b>Warsaw (n)</b>	<b>Moscow (n)</b>	<b>T statistic</b>
<b>Local Government helps small business.</b>	Hinders-5 No influence-41 Helps-4 (50)	Hinders-8 No influence-39 Helps-6 (53)	-.19
<b>Time to register business (months).</b>	.72 (47)	2.71 (51)	5.02
<b>Inspections last year.</b>	9.0 (49)	18.56 (55)	3.46
<b>Percentage of shops fined by inspectors last year.</b>	46 (49)	83 (52)	2.72
<b>Number of different agencies conducting inspections.</b>	2.65 (49)	3.58 (55)	1.84
<b>How legally vulnerable do you feel on scale 1-10.</b>	3.6 (50)	5.1 (55)	3.91
<b>How often does one need to bribe officials on scale 1-5.</b>	2.21 (47)	2.9 (53)	2.52