

CONTRACT ENFORCEMENT IN THE SOVIET ECONOMY¹

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Few studies have attempted to examine analytically various aspects of the contract enforcement institutions in post-Soviet Russia. Researchers agree that the lack of legislation for improving the operation of the legal system, which in turn would enhance the ability of exchange, is producing severe obstacles for economic growth. After the collapse of the Soviet Union, when the administrative hierarchy was destroyed, Russia entered the period of market-oriented reforms with the only sort of contract enforcement mechanism: relational contracting. The latter, although being the only reliable mechanism supporting ongoing exchange in the economy in turmoil, impedes development of more efficient impersonal transactions. Thus, a more workable legal system should emerge to stimulate impersonal transactions. The role of the courts is expected to increase overtime and, eventually, to substitute relational contracting. (Greif and Kandel 1995; Johnson, McMillan and Woodruff 1999)

While earlier studies provide important insights in the institutional workings of the Russian economy in transition, there is a flaw in the understanding of the actual role of legal contract enforcement in the Soviet system. Essentially it is based on the stylized fact that the Soviet command economy lacked any contract law and law enforcement and the centrally designed transactions were maintained via administrative system.

This study focuses on the Soviet experience to outline the institutional conditions that existed at the start of Russian transition. The Soviet institutional infrastructure incorporated two official mechanisms and one informal mechanism for contract enforcement: administrative enforcement, the legal system, and unofficial relational contracting. By construction, administrative and legal

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mechanisms subordinated to the Party and State. The legal system in the form of the Courts of Arbitration had to consider carefully the guidelines of the national plan. The Party/State, however, reserved the right to intervene with the process (Gregory 2001). At any point in time, governmental decrees could annul the whole range of contracts as well as the arbitration decisions. The emergence of unofficial relational networks was due to the following major reasons. First, they helped to compensate numerous disadvantages of the centrally planned economy. Second, whereas the Center, or the Dictator, had an encompassing interest in the productivity of the economy, separate agents had little incentives to support it and could collude to pursue their special interests (Olson 1995). Both forms of the official enforcement targeted impersonal transactions. However administrative enforcement was possible only due to personal affiliation of contracting agents with the Party/State. Relational contracting, on the contrary, was governing personal transactions on the basis of “horizontal trust” that was maintained independently from the Party/State.

A general model of an agent’s choice of enforcement strategy, developed in this paper, demonstrates that relative costs of contract enforcement mechanisms in the Soviet economy determined their complementary use. Periods of nearly total curtailment of contractual relations, accompanied by the administrative governance of transactions, alternated in Soviet economic history with the periods when the role of legal contracts was increasing. Administrative enforcement, although remaining superior to other mechanisms, always yielded some free space for the legal contract enforcement. Relational contracting emerged in order to compensate for the deficiencies of those two. All three mechanisms coexisted throughout the whole Soviet period, although their relative importance varied over time.

The paper argues that in Russia, like in other societies, successful development of market institutions,² should in part rely on healthy relational contracting and collective enforcement. The latter, however, cannot compensate for disappeared administrative enforcement and corrupt legal system. Moreover, Russia inherited distorted patterns of relational contracting from the Soviet past, when it was mostly illegitimate.

The threefold system

Following Olson’s model of dictatorship, we presume that the Soviet Dictator had an encompassing interest in the performance of the society he governed (Olson 1993). It was in the

Dictator's best interest to stimulate efficient economic exchange and to restrain rent-seekers. Yet, we have to make an additional assumption that the Dictator's policies were not costless. The Dictator had to bear certain costs to maintain enforcement mechanisms that would support impersonal transactions producing the desirable outcomes.

The Dictator's principal strategy in commanding exchange was administrative enforcement executed through expensive hierarchical structure. The provision of "loyalty" to the Dictator came essentially from those who intended to benefit from the administrative contract enforcement. The agents manifested their loyalty by promising or producing better outcomes or getting involved in some sort of political exchange with the Dictator.

Nevertheless, no political power could guarantee absolute obedience to the Dictator's orders. First, top authorities had little or no ability to monitor events in the micro level, in the level where actual transactions between the agents took place (Powell 1977). Second, as long as there remained special interests and possibilities for mutually advantageous trade in the economy, there was an incentive for collusion among agents on the expense of Dictator (Olson 1995). These "imperfections" produced a certain threat for the Dictator's power (Wintrobe 1998). Therefore, Dictator was better off instituting supplementary contract enforcement mechanisms. One mechanism, legal contract enforcement, was supposed to create the rules for dispute resolution between agents, when the agents were involved in the transactions beneficial for the Dictator. The second one, let us call it "economic police", was intended to deter agents from performing transactions that were potentially harmful for the Dictator. Both mechanisms required extra expenditures.

Thus, Dictator created threefold enforcement system and allocated "enforcement budget" between the three objectives according to his expectations of returns on each of them. However, the economic agents were not passive executors of the Dictator's will. They were making choices among official enforcement options and illegal relational contracting. This choice depended on the relative costs associated with each type of contract enforcement.

In the next two sections we discuss the evolution of official contract enforcement, peculiarities of unofficial contract enforcement, and the formal model of an agent's choice of enforcement strategy.

² See Greif (2001) on transition to impersonal exchange in pre-Modern Europe.

Evolution of official contract enforcement: Administrative vs. legal

Dominant theoretical view, in 1917-21, implied that after the nationalization all industrial enterprises should form a uniform resource, a single firm. Supply of nationalized enterprises, as well as distribution of their products, was based solely on the government decrees without any horizontal relations.

As the New Economic Policy replaced the “War communism,” *syndicates* that acted as sales representatives for production enterprises took over supplies and industrial distribution. Syndicates were organized on a voluntary basis, and participating enterprises and trusts could market their output through other organizations, such as sales cooperatives, if they felt syndicate commissions were too high (Kantorovich 1928). Fairly successful coexistence of administrative and legal mechanisms of contract enforcement is characteristic of this period: On the one hand, syndicates and trusts have brought disputes to the Arbitration Commissions.³ On the other hand, the State (through VSNKh) controlled contracts that provided governmental orders (Mozolin and Farnsworth 1988: 209-210).

Starting from 1928, the Soviet economic life cycle was purportedly measured in five-year plans. The trust/syndicate distribution system was replaced in 1929 by a new system of supply and distribution organizations attached to the main administrations of economic ministries.⁴ New expansion of the administrative-command regulation undermined contractual relations: investment policy dictated to grant credits exclusively according to the plans, irrespective of concrete contracts; loss-making enterprises received virtually automatic subsidies; unpaid bills were passed up the ladder of the financial system and were made good by state bank (Gregory and Tikhonov 2000). The practice of arbitration courts was portrayed as improper: they were blamed for “misunderstanding the guidelines of the centralized planning” and tendency to base their decisions on the profit-maximization criteria.⁵ (Mozolin and Farnsworth 1988: 216)

As early as in 1931 it became clear that an attempt to create an ‘ideal’ centralized planned economy failed. Institute of contract was recovered and, henceforward, banks required official

³ See *Sbornik reshenii Vysshei Arbitrazhnoi Komissii*, Moscow 1923.

⁴ On December 5, 1929, Party Central Committee issued a decree on “The reorganization of the industrial management,” (*Pravda*, December 14, 1929).

⁵ *Sudebnaia praktika*, 1929, ¹ 14.

contracts in order to authorize credits.⁶ An important transition was made, however, during the short period of ideal planning: First, profit-maximization was no longer an objective for an enterprise. Second, distinction between “planned” and “extra-planned” contracts was introduced. Planned contracts were subject to price regulation by state agencies, while extra-plan contracts continued to rest on negotiated prices, as it was in 1920s (Kantorovich 1928, Bogomolova 1993).

Contracts remained an important part of the Soviet economic system ever since, although contract law and practice changes repeatedly. Janosz Kornai emphasized the continuing role of contracts in the planned economy as follows:

“Yet even with the highest degree of centralization, official rationing [plan] determines only relatively aggregate quotas. Rationing is anyway completed by the ‘business contract’ between buyer and seller in which they agree on the specific quantity, price, time of delivery.” (Kornai 1980: 66)

As the studies of the operation of Gosplan demonstrate, central planners were constantly intent on avoiding planning the distribution of even the most basic products when confronted with the complications of distribution planning (Belova and Gregory 2001, Lazarev and Gregory 2000). Actual distribution was left to the buyers and sellers working through supply agencies and contracts.

The process of distributing materials and equipment was dubbed in the contract campaign (*dogovornaia kampaniia*) that was considered as the final stage of planning. Gosplan and ministerial planning departments created general production targets and provided “limits” of physical and financial resources. The contract campaign’s task was to break the material limits down into actual transactions. Campaigns were governed by the administrative decrees concerning procedures and deadlines, while actual negotiating was done by economic agents in a peer-to-peer manner. A hierarchy was established - *general*, *local*, and *direct* contracts - which defined a system of constraints, supposed to reduce transaction costs. However, the glimpses of the contract campaign reveal a chaotic process that appeared to have little correspondence to the aggregated

⁶ *Sobranie zakonov SSSR*, 1931, ¹ 10 article 109; ¹ 18 article 166.

planning that preceded it.⁷ It was understood that the contract system of the 1930s had inherent problems that could harm the entire economy:

“The organs of supply and distribution are set up in such a fashion that we have a significant brake on the circulation of products and an extremely incorrect regulation of our material wealth. Sometimes, due to the mistakes [of distribution organizations], a whole series of factories are closed while suppliers and distributors bear no responsibility to their customers.” (GARF 8424. 1.1, 8)

By 1934, multilevel system of Arbitration Courts (under the jurisdiction of the central, republican and regional governments, and industrial ministries) was revived in order to enforce contracts on the regular basis. Higher level courts were supposed to consider larger and relatively more important contracts, so, the number of cases resolved at each level was growing from the top down (see Table_1).⁸ Specific branch arbitration courts were established within industrial ministries to speed up contract campaigns and dispute resolution between the enterprises of common affiliation.⁹ The legal system as a whole provided an attractive for the economic agents mechanism for contract enforcement because its narrow specialization in inter-enterprise disputes provided its high productivity: during the period of 1931-33, when the legal contract enforcement was still in embryo, the Courts of Arbitration were able to resolve about 95 per cent of the total number of cases submitted annually at all levels (Table_1).

The Arbitration system's subordinate position implied that virtually any court's decision could be disputed through the administrative hierarchy. Governmental decrees frequently reversed or canceled court decisions. However, this did not make administrative enforcement strictly superior to the legal one. In many cases, when the former failed, the latter was still workable. Price-related disputes were particularly often among such cases because administrative determination and

⁷ Contracting practice of Steel-Supply, the gigantic organization that managed all the metals produced in the country, serves as an example of this process. Steel-Supply itself negotiated general contracts with consumers of metals, but then attached each consumer to specific metals manufacturers to negotiate local contracts. Although the local contractor was the actual supplier, Steel-Supply required that all producers store their products in its warehouses from which the actual distributions were made. Thus, Steel-Supply achieved a virtual monopoly over all distributions of metal in the USSR. (GARF 8424. 1.1,8)

⁸ Unfortunately, no data on the disputes considered by the Arbitration Courts within the jurisdiction of industrial ministries is available, while it is known that they played an important role in resolving conflicts between enterprises.

⁹ They were also subordinated to the State Arbitration Committee under the auspices of the Council of Ministries. *Sovetskoe stroitelstvo*. 1935, ¹ 3(80). *Bulleten finansovogo i khoziastvennogo zakonodatelstva*. 1934, ¹ 1.

monitoring of prices was too burdensome, even if the Dictator made specific pricing-policy provisions:¹⁰ Most prices could not be found in pricing catalogs; if they were, the actual product could be claimed to have different qualities than one found in a catalog. The reports of the Supreme Arbitration Court (*Gosarbitrazh*) cite cases when prices were said to be set “according to a decree” but the decree was not known, or prices were required to be picked up from official price-lists, when no appropriate lists existed, or prices were required to “conform prevailing prices” when no prevailing prices could be determined. Since most contracts specified quantities in value terms, purchasers often ended up with insufficient physical quantities or with incorrect assortments, given that prices were set arbitrarily. Judging by the cases resolved by the *Gosarbitrazh*, confusion about prices and accounting caused more than 50 per cent of all disputes in 1932-34, while disputes about quantities accounted for about 20% (Table 4). Even when a supplier received a direct order from the Center to make a planned delivery, there was no assurance of actual delivery: suppliers were very inventive in finding legal ways to avoid contracts fulfillment, e.g. by dredging up an ambiguous state decree.¹¹

The deadlines for contract completion often had not been met because of the late release of “funds” by central organizations, the late distribution of general contracts, disagreements between production programs and supply plans, the lack of agreement between supply and distribution plans, an insufficient information on direct contracts.¹² Producers/suppliers often refused to conclude contracts on the initial stage.¹³ Here legal enforcement had little power because this sort

¹⁰ For example, the Union-Wool trust gave the order to its supply bases to increase contract prices on average by 60 percent despite the Decree of the Council of Ministers and without approval from the Ministry of Light Industry. (GARF 5446 16.4308: 19 (April, 1935))

¹¹ For example, the cellulose industry ministry had been ordered to supply tar products, of which it was the sole producer, to the supply network. These distribution orders were approved in the state plan. The ministry department refused to fulfill its distribution instructions, citing SNK Decree of December 23, 1932, authorizing it to sell tar directly to customer. To overcome the tar producer’s intransigence, Gosplan sought the state decree requiring the tar producer to fulfill its supply obligations. Without suffering any legal consequences, the tar producer again refused to comply, insisting on its legal right to sell to final consumers. RGAE 4372.31.36: 76-77

¹² For example, the 1935 report on the contract campaign reads that delays in the approval of distribution balances, especially for the Ministries of Heavy Industry and Light Industry were such that the government agreed to extend the contract campaign. See *Biulletin Gosarbitrazha*, No. 4, 1935. 8-9, “First Results of Contract Completion in 1935”

¹³ A chemical producer, for example, refused to enter into a contract with “Industrial Paper” which required it to deliver a fixed annual quantity of a product, although these materials had been allotted personally by the Minister of Heavy industry. Another chemical factory tried to oppose a contract ordered

of disputes were by and large provoked by administrative interventions causing a chain reaction and the Dictator was naturally above the law. However, in its capacity of a signaler to the planners, Gosarbitrazh was able to suggest “fine-tuning” measures, such as calling for changes in production plans and in contracting procedures and rules.¹⁴ For instance, in 1934, Gosarbitrazh proposed to tighten the deadlines for completing contract negotiations and to place the same responsibility for contract fulfillment on general contractors (typically, ministries) as on local contractors (mid-level economic administrators) for the timely completion of contracts and their fulfillment. High-level bureaucracy threatened by the proposal complained that if they had to assume more responsibility for contracts, the responsibility borne by the local contractor would be weakened. They also objected that, in many cases, the local contractor was not subordinated to the general contractor, so that a general contractor had no effective lever to apply. Gosarbitrazh’s insisted that the general contractor would only be held responsible for its actions and could act against local contractors through legal measures. This meant essentially that ministry would have to take a trouble of suing a lower-rank body, which was against the logic of bureaucracy.

In the first half of 1930s, long-term (normally, annual) general and local contracts had the decisive role, whilst the applicability of direct contracting was conditioned on numerous rules.¹⁵ The routine of several years called for increasing the role of *direct short-term* contracts during contract campaigns starting from 1936.¹⁶ Ultimately, permanent lack of responsibility of the parties involved in general and local agreements caused such a change since it was not them who completed actual transaction.

The objective of the system of Arbitration Courts was to give the economic agents incentives to seek dispute resolution instead of breaking contracts and to relieve administrative hierarchy from

by the Council of Ministers to deliver equipment for collective farms by August, 1934, stating that they were not able to fulfill the order by that date. Another factory refused a local contract with “Union-Distribution” arguing that the quantities and dates in the general contract were not acceptable. GARF 5446.16.4083, 52-60 (1934)

¹⁴ For example, in 1933, Gosarbitrazh discovered that Rare-Metals-Union’s production plan assumed such assortment of metals that made it impossible for an export organization to meet its export plans. Following Gosarbitrazh’s proposal, the Ministry of Heavy Industry and the Ministry of Trade reconsidered Rare-Metal-Union’s production plan. GARF 4086. 16,32.

¹⁵ Prior to this, sphere of direct contracting was restricted to cooperative unions; and short-term contracts were allowed mostly in case of seasonal goods delivery. *Bulletin finansovogo i khoziastvennogo zakonodatelstva*. 19??, ¹ ?.

¹⁶ *Bulleten finansovogo i khoziastvennogo zakonodatelstva*. 1936, ¹ 7.

the burden of petty decision-making. To facilitate easy dispute resolution, arbitration courts received subsidies from the budget of corresponding territory or ministry.¹⁷ Disputing parties did not bear any litigation costs; their expenses were limited to submission fees which were set to constitute a negligible share of percent of claimed amounts (see e.g., Table_5). This objective suffered, however, from an unintended consequence: exceedingly low costs of legal contract enforcement caused an avalanche of lawsuits.

Probably, the problem became especially acute in the second half of 1930s. In November 1936, Deputy ministry of Light Industry indicated that in ten months of the year, arbitration court of that ministry considered 14,410 cases (which means that on average every enterprise had been engaged in more than one suit); he accused the enterprises in their preference for using arbitration courts over peer settlement, especially, when it concerned order of payments.¹⁸ In January 1937, Minister of Heavy Industry, ordered enterprise directors and chief executives to refrain from any “redundant” disputes; to negotiate mutually acceptable solutions without filing lawsuits; arbitration courts were asked to inform the ministry about the origins and participants of nuisance disputes.¹⁹ Every contract campaign started with an administrative warning against needless suits. Tendency to force the enterprises to internalize disputes resolution showed in the reduction the number of disputes in the late 1930s (Table_1a).

The contractual law accepted by 1941 with minor changes was used during the WW II period. Despite an increase of administrative governance of supply and distribution in some industries, a contract still had to precede any ongoing transaction. Even new conditions caused by the war could not serve as an excuse for contract violation (Mozolin and Farnswort 1988: 223).²⁰ In the late 1940s, the authority of enterprises was extended to include participation in determining the terms of general and local contracts, which had been an exclusive prerogative of ministries. During 1950s the role of legal contract enforcement was continuously growing. New legislation was introduced to

¹⁷ See e.g., *Bulleten finansovogo i khoziastvennogo zakonodatelstva*. 1935, ¹ 2.

¹⁸ *Bulleten finansovogo i khoziastvennogo zakonodatelstva*. 1937, ¹ 11. The decree of the deputy chairman of the Ministry of the Light industry, November 19, 1936.

¹⁹ *Bulleten finansovogo i khoziastvennogo zakonodatelstva*. 1937, ¹ 4.

²⁰ See also *Sudebnaia praktika Verkhovnogo Suda SSSR*, Moscow, 1942 ¹ 1 and 1943 ¹ 3.

regulate credit operations.²¹ In 1957 direct contract, which allowed for the greatest freedom of involved parties in defining the terms, was accepted as a dominant form of transactions. At about the same time, the General Code was adopted that allowed to improve legal enforcement of transactions concerning supply and distribution.²²

The high ratio of resolved cases, in combination with low costs, provided a strong motivation to seek dispute resolution in the Courts of Arbitration (Table_1a). Already in 1934, 327 thousand cases were resolved. The number of disputes filed in the Courts of Arbitration grew steadily until 1972 with slight fluctuations.²³ By the end of 1970s, the average number of cases was about 650 thousand per year.

Unofficial contract enforcement: relations and reputation

The studies of the Soviet economy, starting with the pioneering work of Joseph Berliner (1957), identified the phenomenon of middle-man (*tolkach*, or *snabzhenets*).²⁴ Frustrated industrial consumers could not rely on products delivered through the official supply channels and began to develop the informal markets that were known to have characterized the mature system. Eventually, relatively stable networks of personal relations emerged that helped to secure repeated transactions crosswise the economy and provided unofficial mechanism for contract enforcement.

In general, *tolkachi* were to persuade suppliers to deliver both the planned amounts of materials (which is by no means certain) and supply in excess of those planned. Good *tolkachi* were costly. Expenses included not only salaries, travel and living expenses, but also incentives to outcompete the *tolkachi* of dozens of other desperate enterprises. In addition, *tolkachi*'s job was

²¹ Decree on "the Role and tasks of the State bank of the USSR", August 21, 1954 see in Direktivy KPSS i Sovetskogo pravitel'stva po khoziaystvennym voprosam, Moscow, 1958.

²² See *Sobranie postanovlenii SSSR*, 1959, ¹ 11.

²³ Van den Berg (1985) uses Bogoliubov's data to obtain the number for 1972. According to Bogoliubov (1973), the number of disputes decreased in 1972 for the first time in the many years.

²⁴ Probably, the honor of detecting the phenomenon of *tolkachi* belongs to Rabkrin. Inspectors also encountered such forms of economic opposition as hiding the stocks, deliberate exaggeration of the needs, and disorganization of construction and production. In 1921 and in 1922, Rabkrin uncovered and brought before the courts a total of respectively 2,385 and 2,682 cases of abuse of office, mismanagement and corruption. (See more on this in Rees 1987) Little effort was applied, however, to investigate the roots of these phenomena. Inspectors purged and punished seemingly guilty people, blaming different groups in different periods, organizing campaigns and show trials but, apparently, without any significant accomplishment. After Rabkrin was abolished in 1934, its successors inherited all the same problems and no effective tools except for repression.

risky, and managers had to offer them a generous contract.²⁵ Although it is impossible to measure precisely the expenditures associated with *tolkachi* business, the archival material allows us to get some impression: In 1935, plenipotentiaries of the Party Control Commission (KPK) visited 12 factories learning that typically 25-35 supply agents were present at a factory each day; some of them stayed uninterruptedly during a long time. Even an extremely cautious estimation revealed that total amount of some 400-500 million rubles was spent annually in order to pay *tolkachi*.²⁶

It was not a secret that there was a positive probability of punishment associated with *tolkachi* business. Nevertheless, in the Soviet system, even a loyal manager, facing the dilemma, to accept plan failure or to try to obtain additional resources through semi-legal channels, would have chosen the second and thus disobey rules (Belova 2001). From the Dictator's viewpoint, *tolkachi* undermined governmental control over resource distribution, and were outlawed. At the same time, it was evident that some business mediation was inevitable, just as the institute of contract was. As a result, Soviet Dictator accepted ambiguous attitudes toward middlemen, which is illustrated by the decision made in the case cited above: Ministry of Internal Affairs was put in charge to arrest and/or send out any agent who came to a factory without a special permit issued by a minister. Thus, the same person was a notorious *tolkach* or respectable "supply agent" depending on the kind of paper in hand.

Transportation was one of the fields, where intermediary business flourished. Normally, transactions required a contract between producer/buyer and a shipping company. Such contracts were based on the general distribution plan. Both shipping company and its client needed protection against contract violation.²⁷ Transportation system exhibited especially low rate of contract

²⁵ For example, the chair of Rostov supply agency (Ukrainian branch of the heavy industry) proposed the following contract to his *tolkachi*: fixed salary of 400 rubles; extra 6 rubles for shipping/loading of each planned carload of metal, if it was above 80% of planed amount; an extra 12 rubles for each additional load of low quality metal (which was also a valuable input); living expenses of an agent were set equal to the day-wage paid at the official work place.(KPK files 6-1- 40, 108-117).

²⁶ In average, *tolkachi* received about 1,700 rubles as travel allowance (for a short-term trip), plus the regular salary of equal amount. It amusing that one of the KPK plenipotentiaries greatest concerns was the "colossal and unnecessary traffic of *tolkachi* across the country that overloads public transportation system."(KPK files 6-1-48. The Minutes of the Bureau of KPK, ¹ 26, May, 23 1935)

²⁷ In 1935, a dispute arose between the factory that produced carriages and the Ministry of Transportation. The latter refused to purchase carriages, claiming that the quantity and quality of the product did not satisfy the contract terms. KPK called upon the Party/State for administrative enforcement of this contract.(KPK files 6-1-28,1 – 5)

compliance because of delayed shipment, unfair charges, as well as tolerance to frequent theft, unauthorized sales of cargo, transshipment troubles,²⁸ inappropriate storage, and weak administration.²⁹ In order to protect themselves, clientele of the transportation system hired intermediary agents (“commissioners”), who were to obtain compensation from shipping companies in cases of theft or damages.³⁰ These agents proved to be efficient and railroads paid millions of rubles in fines to their customers.³¹

The Soviet authorities, however, recognized the middlemen services as inadmissible and the clientele’s claims were classified as unjustified and reflecting “the presence of self-seeking tendencies”. The Ministry of Internal Affairs was put in charge to investigate activities of all intermediary agencies; some judges and railroads’ directors were dismissed. Finally, it was decided that intermediary agencies are to be abolished and special attention was brought in to coordinate transportation courts. The Ministry of Transportation complaints caused by huge losses were in tact with Dictator’s preference to avoid unpredictable flow of financial resources by stimulating the legal enforcement.

It is worth mentioning, that both judges and middlemen had negative reputation: The courts were often accused in tolerance toward illegal practices. The middlemen usually had bad career records; many of them have been previously fired from the transportation organizations because of various offenses. For Dictator, however, courts represented more reliable enforcement organization than independent intermediaries.

²⁸ The KPK plenipotentiaries reported numerous failures of staging posts in Stalingrad and Saratov. Only 10-20 per cent of the technological capacity was used; transshipment did not follow the planned contracts and “no one knew where and how much cargo should have been shipped”(KPK files 6-1-34, 140-145). In the first quarter of 1934, about 25 per cent of all the transshipment were unplanned, although Ministry of Transportation systematically reported them as outlined. (KPK files 6-1-23, 35).

²⁹ In 1933-34, KPK reported several investigations related to unfulfilled deliveries and exaggerated requests for shipment.(KPK files 6-1-29, 99-101; 6-1-29,112) Several railroads managers were accused of irresponsible use of the rolling stock and punished. (KPK files 6-1-34, 121-130).

³⁰ In 1932 in Odessa region of the South-West railroad, the cargo of 57 thousand rubles value was stolen, in 1933 - of 83 thousand rubles; in the first half of 1934 - 137 thousand rubles. 1,883 cases of embezzlements and 6,163 cases of short weight and cheating have been reported on Perm railroad in the first half of 1934. (KPK files 6-1-37, 22 – 40)

³¹ E.g., in 1933, Yekaterininskaia railroad paid 2,252 thousand rubles fine, and in the first half of 1934 it paid 9,753 thousand rubles fine. In the first half of 1934, Samaro-Zlatoustovskaia railroad paid 2 million rubles, Perm railroad paid 4 million rubles, Riasan-Ural railroad paid 1.3 million rubles fines. (KPK files 6-1-37, 22 – 40)

Reputation played a significant role in the Soviet economy. It is important to understand, however, in what way the information on reputation was collected and disseminated. The literature on the institutions that enforce contracts shows that community enforcement provided necessary support to increase the rate of compliance (Greif 1989, 1993; Greif, Milgrom, and Weingast 1994). Given no formal obstacles to emerge and ability to work in its own interest, a community facilitates effective information transmission (Greif 1993). However, in the Soviet environment, the economic society did not have freedom of organizations (Olson 1995). The only form of reputation that was officially recognized and actively stimulated was the loyalty to the Dictator. The Soviet managers received privileges, rewards and enjoyed “quiet life” as long as they explicitly manifested their loyalty to the Dictator (Berliner 1957). Thus, the official reputation was organized “hierarchically”.

The studies of economic offenses in the Soviet economy indicate the Dictator’s awareness of the fact that unplanned transactions became possible as the result of relational contracting (Lampert 1985; Belova 2001). The horizontal networks grew up accumulating the information about reputation and skills in the process of repeated transactions. By all means, it was the Dictator’s intent to oppose the horizontal trust to develop, since this posed a threat to his power (Wintrobe 1998). Yet, collusion among the Soviet managers became possible as they eventually developed trust in one another (Olson 1995).³²

Agent’s choice of contract enforcement

Each agent in the economy has access to a set of feasible strategies for contract enforcement which includes administrative and legal enforcement, and relational contracting $\{S_A, S_L, S_R\}$. Payoffs are determined by the cost structure. Neither strategy is individually costless. The costs of each strategy and payoffs distribution function are common knowledge. The costs of enforcement

³² Indeed, the Dictator’s attitude to the economic offenses was not uniform: in some instances managers were receiving warnings or mild penalties, in the others, they were punished severely (Berliner 1957; Getty 1985; Rees 1987). Although there is lack of studies revealing precise dependencies between characteristics of an offense and the rate of punishment, a fair conjecture would be that “unselfishness” and high performance secured those engaged in relational contracting. Observed patterns of punishment reversals imply not only the possibility of reprimand removal but also of restoration to the party ranks after some period for virtually every expelled party member. Repeated catch phrases were “allow to reconsider the case in a year on a petition from the party cell,” or “prohibit to occupy responsible positions for 2 (3) years” or “taking into account a considerable record of success in the economic front and the lack of selfish motives (and/or sincere penitence) restore in the party membership” (Belova 2001).

is defined as a combination of fixed costs and individual costs. Prior to the discussion of the possible outcomes of the choice of enforcement strategies, we need to make a set of assumptions about fixed and individual components of the cost function.

The fixed costs of enforcement

For each strategy, at each moment, fixed costs of enforcement are contingent on the Dictator's policies; and, therefore, are externally determined. The Dictator chooses policies rationally, according to his preferences, which are not the issue here per se. Rather we are concerned with the agents' choices for whom Dictator's actions come as external shocks.

The Dictator collects resources nationwide and spends a portion of his revenue, an enforcement budget (B_E), to enforce the transactions, which increase his power, as opposed to agents' self-serving transactions, whereby they appropriate portion of revenue claimed by the Dictator. According to the Dictator's preferences, in each period, a certain amount is allocated among the following alternatives:

- 1) to enforce fulfillment of Dictator's orders (administrative enforcement);
- 2) to subsidize the legal contract enforcement system;
- 3) to suppress unauthorized (unplanned) transactions - deterrence of "economic crime".

For the purpose of simplicity, let us make the following assumptions about the pattern of revenue allocation (about Dictator's preferences):

- 1) One portion of B_E covers the entire costs of the maintenance of the administrative infrastructure.
- 2) The remainder of B_E is divided between the legal contract enforcement system and deterrence of economic crime. The higher the subsidies and the more developed the legal system, the lower are costs of legal enforcement. Any shift in Dictator's preferences, resulting in lowering of the individual costs of legal enforcement is feasible only at the expense of deterrence. Thus, Dictator's preferences determine the relative costs of legal and relational enforcement for the agents. The costs of maintaining illegal relations for the agents negatively correlate with the funding of deterrence.

Individual costs of enforcement

In addition to fixed costs which are equal for all agents, every agent bears individually determined share of costs. Individual costs may depend on various attributes of an agent and/or particular contract. We will focus on the following:

- 1) In order to use administrative enforcement, an agent should pay in exchange for the support from the Dictator; or, in general, from a powerful decision-maker in the Party/State hierarchy. The higher the proximity to the Dictator, the lower are individual costs; or, in other words, the greater is the probability that Dictator would support an agent's petition to resolve a conflict in his favor.
- 2) The Dictator subsidizes costs of legal enforcement only partially and all the necessary extra expenses are split between plaintiff and defendant, but direct costs of court procedure depend only on the claimed amounts.
- 3) In order to use relational contracting, agents invest in establishing personal networks, and "counter-deterrence". These investments accumulate into *social capital*, which is used repeatedly in further transactions. The less the Dictator spends on deterrence of economic crime, the wider are personal networks, the greater is social capital and the lower are individual costs of relational contracting.

Enforcement choice problem

Agent's profit from a transaction is the difference between revenue, associated with a contract, and the cost of its enforcement: $\tilde{I} = R - C_E(\cdot)$. Given that for any particular contract R is constant, i.e. does not depend on the way it is enforced, an agent's objective is to minimize (expected) enforcement cost: $\min C_E(Ac, Lc, Rc)$, where Ac , Lc , and Rc are costs of S_A , S_L , and S_R , respectively. The agent's choice is conditional on the choice of another contractor.

Under our assumptions, the general form of enforcement cost function has the following structure: $C_E(Ac, Lc, Rc) = f(Ac, Lc, Rc) + i(Ac, Lc, Rc)$, where $f(\cdot)$ is a fixed component, and $i(\cdot)$ is an individual component.

Without loss of generality we can assume that fixed costs function is homothetic, i.e. changes in the size of enforcement budget do not alter Dictator's pattern of allocation of B_E . Then fixed costs component can be represented in the form: $f(\cdot) = F + e_f$, where F is a component determined by the size of enforcement budget B_E constraint and e_f reflects current allocation of B_E . As long as the Dictator's choices do not change relative costs of enforcement, an agent's problem is reduced to minimization of individual cost function: $C_E(\cdot) = F + i(\cdot)$. External shocks affect fixed costs ratios e_f and, therefore, change the costs of enforcement: $C_E(\cdot) = F + i(\cdot) + e_f$. In general $cov(i, e_f) \neq 0$, that is, individual costs can be also indirectly affected by reallocation of enforcement budget. For example, social capital is more costly to accumulate when increasing deterrence expenditures cause probability of punishment for illegal contracting to increase.

Equilibrium strategies

As long as all three strategies are available, multiple equilibria in pure strategies is possible, iff both parties entering into a contract always choose the same enforcement strategy. A plausible way to model this situation is by suggesting a “hard-partitioned” economic society represented by three groups of agents. Imagine, that any rank-and-file *loyal* agent uses exclusively legal mechanisms to enforce an official contract, which is based entirely on the Dictator’s plan; all rank-and-file *selfish* agents rely solely on unofficial relational contracting. Finally, there is a group of politically empowered agents, “members of the Dictator’s retinue,” who enjoy easy access to administrative enforcement. The costs of each strategy are subject to the allocation of B_E and members of the groups are not allowed to mix up.

Indeed, within each group, individual costs of enforcement are minimized and in the absence of external shocks commitment to a pure strategy yields the best outcome. For instance, within the group of loyal agents, exclusive reliance on the legal settlement of disputes allows an equilibrium solution due to the high rate of compliance. In other words, it is a common feature of each member of the group to do the best to fulfill the Dictator’s task. However, pure strategy equilibrium is not robust against the shifts in Dictator’s preferences, resulting in arbitrary denunciation of contracts or in the reallocation of enforcement budget. As long as the assumption about irreplaceable strategies holds, external shocks threaten to increase individual costs and to force a shift toward a worse outcome. If we allow for a substitution between strategies, then agents can secure an outcome either by applying for an administrative support in order to reverse a court’s decision, or by engaging in relational contracting. An examination of remaining two groups yields similar result. Neither of them can offset an adverse shock using a single strategy.

‘Hard-partitioned’ society is an unrealistic hypothesis. In reality, different types of agent engage in the contracts. An agent has to fulfill a multidimensional planned task, which requires many inputs; so that an agent needs to enter into multiple contracts across the economy. It is irrational to expect that any contracting party always has a preference for the same strategy as this agent prefers. Administrative enforcement works well against the agents with weaker political connections, but an agent turns out to be helpless against a higher-ranking contractor if he relies exclusively on administrative enforcement. At the same time, persistent problems of planned economy forced virtually all agents to resort to illegal transactions and unofficial enforcement. This

made all three enforcement strategies complementary in the sense that every agent had to use all of them depending on circumstances.

“Crowding-in” effects

Under certain conditions, determined by costs ratios, agent may tend to “crowd-in” into one particular strategy. This has negative effect with a possible exception of relational contracting. When administrative enforcement becomes more attractive, individual costs of this type of enforcement will grow: First, in order to be able to distinguish between agents, Dictator might increase a barrier to entry into the retinue. Second, the larger the Dictator’s retinue, i.e. the more often the Dictator grants his support in exchange for promises, the less is comparative advantage for the agents that use administrative enforcement. When individual costs of legal enforcement go down, two outcomes are possible. First, this can lead to an exchange-improving outcome since sufficiently small costs ensure that agents will seek dispute resolution, rather than sever their relations, should dispute arise (Ramney and Watson 1999). Second, an adverse effect occurs, if the verifiability of information is costly and individual expenses are too small. The in-court dispute resolution grows preferable over the renegotiating process. As a result, the legal system becomes overloaded and fixed costs of legal enforcement rise.

The relational contracting, on the contrary, benefits when personal relations spread out. An incentive to collude at the expense of Dictator increases in case there is possibility to avoid punishment. Thus, social capital starts to accumulate in small groups which can cover up special-interests actions more effectively (Olson 1995). Growth of social capital leads to the dissipation of rents and, eventually, to the decline of Dictator’s power (Wintrobe 1998). As returns to social capital increase, it becomes more beneficial even for the retinue to rely on the horizontal trust. Prospering relational contracting has negative effect if costs of legal enforcement are too high. Strong personal ties between buyers and sellers block more efficient exchange.

Conclusion

Throughout this paper we considered the Soviet contract enforcement infrastructure as a threefold system consisting of two official and one unofficial mechanism. The study of the evolution of official contract enforcement shows that the legal system emerged partly against, partly owing to the power of the Soviet dictator. The principal task of official contract enforcement was the provision of impersonal exchange that targeted the fulfillment of Dictator’s directives.

Unofficial contract enforcement emerged against Dictator's will and flourished despite the deterrence and punishment. It targeted personal transactions and relied upon horizontal relations and reputation irrespective to the Dictator. The central authorities discredited relational contracting since it served as an efficient way to serve special interests as opposed to the Dictator's supposedly encompassing interest.

Allocation of the enforcement budget and the cost structure of enforcement strategies serve as the inputs for the agents' choice problem. Shifts in the relative costs of the threefold system components stimulate complementary use of contract enforcement strategies by affecting individual costs ratios. Equilibria in pure strategies are possible only in "hard-partitioned" economic society, which by no means is a realistic condition. Also these equilibria are not robust against external shocks that change relative costs of enforcement strategies. The agents choose a mix of strategies that minimize their individual costs of enforcement. Although not necessary optimal, complementary use of strategies helps to secure better outcomes of the repeated transactions and, thus, is considered as a superior solution of the agent's enforcement choice problem. "Crowding-in" effects demonstrate that normally individual costs of enforcement rise as demand for a particular strategy increases. The exception is the relational contracting, which starts to flourish as incentives to cooperate increase.

Coexistence of the three mechanisms for contract enforcement has put an imprint on the contemporary contract enforcement system. Inertia is certainly a characteristic of this system and it is not enough to rewrite the legal code to overcome it. The mix of enforcement strategies used by Soviet agents was influenced to a large extent by the Dictator's preferences. Russian enterprises entered transition with a set of contract enforcement strategies which was no longer adequate. Disassembled official infrastructure resulted in virtually complete loss of administrative enforcement, while the costs of legal enforcement increased. In this circumstances, personal relationships remained the only reliable mechanism to support repeated transactions. It seemed that nothing prevented this mechanism from flourishing. Yet, the system needed time to adjust to the new cost structure. The system met both the deficit of social capital and lack of appropriate legal enforceability. In addition to ceasing subsidies, economic disorganization caused the rise in information costs and drove up the individual costs of legal enforcement. The stock of social capital, in its turn, could not grow overnight to compensate for all the changes. Being under

permanent deterrence during the Soviet period, personal networks inherited inappropriate shape and size.

Ironically, the deficit of social capital not only impeded the spread of relational contracting, but also prevented the development of impersonal exchange. As Greif (2001) has demonstrated, successful transition to impersonal exchange depends, to a great extent, on the access to *intra-community* enforcement as well as on the information transmission. Individual costs of legal enforcement will become lower when healthy networks and organizations will emerge that will stimulate information transmission and cultivate reputation.

Archival sources

References to archival material are given in the following notation: Archive Fond.Register.File: Page.

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- Fond 5446, Sovnarkom;

- Fond 5674, STO;

RGAE (the Russian State Archive of the Economy)

- Fond 1562, TsSU (Central Statistical Bureau);

- Fond 4372, Gosplan.

Hoover Archive (the Hoover Institution for War, Peace and Revolution)

- Fond 6. KPK files. Documents of the Communist party and the Soviet State. Party Control Commission. Originals are held in the former archive of the Central Committee of the Communist party of the Soviet Union (now RGANI), Moscow.

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Appendix

Table 1. Number of Disputes considered by State Arbitration

Absolute number of cases submitted		Total amount of claims (th. rubles)	Number of cases resolved	Total amount of resolved disputes (th. rubles)	Source
• Arbitrazh SNK SSSR					
1932	n/a	n/a	4,678	808,467.6	GARF 8424.1.2,1-2
1933	5,800	n/a	5,482*	660,663.4	GARF 8424.1.8,11; 8424.1.5,72
	plus precontractual disputes		1,185	n/a	
1934	5,158	592,417	4,844	545,760	GARF 8424.1.8,11
• Arbitrazh SNK RSFSR					
1933	8,195	n/a	7,786	186,736	GARF 8424.1.8,11
1934	8,156	n/a	7,802	185,514	GARF 8424.1.8,11
• Arbitrazh City of Moscow					
1933	58,490	408,171	56,040	378,422	GARF 8424.1.8,11
1934	61,059	375,092	58,652	363,678	GARF 8424.1.8,11
• Arbitrazh City of Leningrad					
1933	n/a	n/a	37,897	381,945	GARF 8424.1.8,11
1934	39,073	398,472	38,351	392,120	GARF 8424.1.8,11
	including precontractual disputes		1,830	10,318	

*This number does not include changes in contracts (=123) and cases that have been resolved by the Chief Arbiter (=86) [GARF 8424.1.5,72]

Table 1a. Number of cases and precontractual disputes considered by Arbitration Courts of USSR and RSFSR

Number of cases (th.)			Precontractual disputes (th.)			
USSR		RSFSR	USSR		RSFSR	
Year			abs. number (thous.)	as % of all disputes	abs. number (thous.)	as % of all disputes
1934	327					
1935	400		20	5		
1936	404					
1937	362					
1938	330					
1950	440		15	3		
1953	470		63	13		
1954	460		50	11		
1957	420		26	6		
1958	480		42	9		
1964	590	356	81	14		
1965	570		68	12		
1966			76		42	
1967						
1971	760		91	12		
1972	730	442.6			48	11
1973	700					
1974	700	423	80	11		
1975	660	400				
1976	650	394			47	12
1978	620					
1979	650					
1980	690					

- 1934: GARF 8424.1.8,11(I);
- 1935-1980: Ger P. van der Berg. *The Soviet System of Justice: Figures and Policy*. Martinus Nijhoff Publishers, 1985.p.170, Table L; p.238, Table 56; 58; 59.
- 1950-65: van der Berg, Table 59. Van den Berg uses Petrov's graphs to reconstruct absolute numbers. (Petrov, *Otvetstvennost' khozorganov za narushenie obiazatel'sv*, Moscow 1975)

Table 2. Cases resolved by Arbitrazh SNK RSFSR

The case of	The number of cases			Total amount of claims (thousands)		
	1932	1933	1934	1932	1933	1934
• Consumer Cooperation	370	541	649	259,400.4	61,437.4	50,478
• Heavy Industry	1248	1346		149,013.0	153,099.4	
• Light Industry	618	496		79,938.3	42,956.9	
• Food Industry	444	328	479	75,893.2	38,915.8	41,939
• Agriculture	313	216		57,181.2	44,868.2	
• Construction	556	787	596	61,836.0	119,933.1	86,461
• Wood & Paper Industry		241			23,967.9	
• Transportation system	257	376	265	39,118.9	70,486.7	41,876
• Trade	64	295		21,238.2	24,383.3	
• Entertainment business	169	163		10,691.1	16,000.1	
• Export/Import	94	142	382	11,183.1	16,989.4	53,332
• Industrial cooperation	114	171		5,663.4	12,880.7	
• Utility	33	23		2,030.3	1,330.4	
• Administrative org-s	26	63		1,603.8	5,228.1	
• Health care org-s	9	21		1,970.2	1,663.2	
• Communication services	16	36		336.8	3,660.2	
• Intraindustry supplies			1487			149,983
• Supplies to Agriculture			163			9,140
• Procurement of Agricultural goods			226			22,776
• Supplies to the transport			242			37,545
• Others		237	669		23,762.6	98,887
• Precontractual disputes		5568				
• Changes in contracts		123				
• Total	4678	6790		808,467.648	691,486.4	

Sources: The data on 1932 from GARF 8424.1.2:1; the data on 1933 from GARF 8424.1.5:72; the data on 1934 GARF 8424.1.8:2

Table 3 Classification of cases resolved by All Courts of Arbitration in 1934 (*)

The case of	Absolute number	% of total
• Consumer goods (<i>shirpotreb</i>)	45,186	13.8
• Food (<i>prodtovary</i>)	43,688	13.3
• Intraindustry supplies	93,192	28.8
• Export-Import	2,618	0.8
• Construction industry	16,388	5.0
• Transportation	15,627	4.8
• Supplies to Agriculture	11,539	3.5
• Procurement of Agricultural goods	10,075	3.0
• Supplies to Transport	7,520	2.3
• Other cases	81,274	24.7
• Total	327,107	

(*) **Source:** GARF 8424.1.8,6

Table 4 Characteristics of the cases resolved by Arbitration of SNK RSFSR

Claims on	Number of cases			Total amount claimed (thousands of rubles)		
	1932	1933	1934	1932	1933	1934
<ul style="list-style-type: none"> • (I) the quantity and short weight including: penalties and forfeit • of them resolved including: penalties and forfeit 	1,267	894 654	852	144,747.9 114,628.2 39,969.0	116,129.8 92,612.6 43,019.8 31,497.2	96,341
<ul style="list-style-type: none"> • (II) the accounting and prices including: penalties and forfeit • of them resolved including: penalties and forfeit 	2,555	4,038 3,156	3,156	594,579.6 16,448.7 448,003.3	499,453.5 14,781.9 265,534.4 5,673.2	363,854
<ul style="list-style-type: none"> • of (II) the accounting including: penalties and forfeit • of them resolved including: penalties and forfeit 		3,898 3,049	2,935		484,101.4 14,781.9 256,225.6 5,673.2	328,195
<ul style="list-style-type: none"> • of (II) the prices • of them resolved 		140 107	221		15,352.1 9,308.8	35,659
<ul style="list-style-type: none"> • the quality including: penalties and forfeit • of them resolved including: penalties and forfeit 	109	249 192	427	1,451.6 3,301.1 4,601.5	24,669.1 9,352.7 12,579.5 5,045.3	36,371
<ul style="list-style-type: none"> • Precontractual disputes including: penalties and forfeit • of them resolved including: penalties and forfeit 	733			2,724.4 5,508.3 1,032.8		
<ul style="list-style-type: none"> • Annulment/changes in contracts • of them resolved 		123 97			986.5 457.0	
<ul style="list-style-type: none"> • Others including: penalties and forfeit • of them resolved including: penalties and forfeit 		159 106	409		16,204.4 6,442.1	43,836
<ul style="list-style-type: none"> • of TOTAL Resolved with forfeit 			1,507			20,428
<ul style="list-style-type: none"> • TOTAL 	4,664	5,463	4,834			

Sources: for 1932 GARF 8424.1.2:2; for 1933 GARF 8424.1.5:71; for 1934 GARF 8424.1.8:1-2;

Table 5. Filing fees. Industrial Arbitration Courts

Arbitration of the Ministry of Timber Industry ¹⁾ 1935	
amount of dispute (rubles)	processing fee (rubles)
< 25,000	40
50,000	60
100,000	75
>100,000	125
Arbitration of the Cooperative Unions ²⁾ 1937	
amount of dispute (rubles)	processing fee
<500	5 rubles
< 25,000	1%
<50,000	0.25%
<100,000	0.2%
<500,000	0.1%
>500,000	0.05%

¹⁾ *Bulleten finansovogo i khozianstvennogo zakonodatelstva*. 1935, ¹ 2 There was no processing fees for precontractual disputes.

²⁾ *Bulleten finansovogo i khozianstvennogo zakonodatelstva*. 1937, ¹ 8-9 Given the necessity to stimulate an immediate turn to the arbitration court, even such moderate amounts of filing fees were subject to reduction conditioned on the timing: If a case was submitted within one month after a dispute arose, there was a 50 per cent cut; and the cut was 25 per cent if a case was filed within 3-4 months.

If an arbitration court failed to resolve a dispute (or passed it to the state arbitration court), all fees had to be returned.