

Resolutions, Recoveries and Relationships:  
The Evolution of Payment Disputes in Central and Eastern Europe

by

William Pyle

September 2005

MIDDLEBURY COLLEGE ECONOMICS DISCUSSION PAPER NO. 05-23



DEPARTMENT OF ECONOMICS  
MIDDLEBURY COLLEGE  
MIDDLEBURY, VERMONT 05753

<http://www.middlebury.edu/~econ>

**Resolutions, Recoveries and Relationships:  
The Evolution of Payment Disputes in Central and Eastern Europe**

**William Pyle  
Middlebury College  
Middlebury, VT 05753  
(802) 443-3240  
[wpyle@middlebury.edu](mailto:wpyle@middlebury.edu)**

Resolutions, Recoveries and Relationships:  
The Evolution of Payment Disputes in Central and Eastern Europe

*Abstract:* What determines the mechanism chosen to resolve a commercial dispute? To what degree does the aggrieved recover damages? And does the relationship survive in the aftermath? The answers to these questions affect expectations as to the costs of transacting and, thereby, the development of markets. But they have received almost no attention in the economic literature on the post-socialist transition. This article exploits a rich survey of small and medium-sized manufacturing enterprises in three Central and East European countries to explain responses to an inter-firm payment dispute. The evidence suggests that behavior at successive stages is strongly influenced by the transaction costs associated with greater geographic distance between the firms. The evidence also strongly suggests that the costs of a dispute can be mitigated by membership in a business association.

JEL classification: D23, D74, K40, K41, P37

## **Resolutions, Recoveries and Relationships:**

### **The Evolution of Payment Disputes in Central and Eastern Europe<sup>1</sup>**

#### **1. Introduction**

Throughout history, the expansion of markets has depended upon the development of mechanisms to uphold agreements and resolve disputes. By raising the costs of non-compliance, effective enforcement institutions reduce the incidence of contractual violations, thus emboldening otherwise reluctant firms to widen their circle of trade partners. The post-socialist experience has re-focused attention on this fundamental lesson of “market building.” From mafia organizations, to bilateral and multilateral relational mechanisms, to the nascent court system, transition countries developed, in relatively short order, a diverse array of institutions for imposing costs on parties that renege on commercial agreements.

Although a fair number of studies describe these institutions and illustrate how they contribute to the expansion of markets, few have actually made what they are designed to prevent – commercial disputes – the unit of analysis. In spite of the evolution of institutions to prevent them, commercial disputes still occur – and possibly with greater frequency.<sup>2</sup> When they do, we are not well informed as to what happens next: What determines the mechanism chosen to resolve the dispute? To what degree does the aggrieved party recover damages? And does the commercial relationship survive in the dispute’s aftermath? It is not unreasonable to believe that the answers to these questions affect general expectations as to the costs of transacting and, thereby, the development of markets. Nevertheless, these questions have received almost no attention in the economic literature on the post-socialist transition. The one noteworthy study that considers the evolution of business disputes is

based on a half dozen case studies (Hendley, 2001). None use, as here, the power of large micro-datasets to address these matters.

This article sheds light on dispute resolution within a specific transitional context. Using a 1997 survey of small and medium-sized manufacturing enterprises in Poland, Slovakia and Romania (Johnson, McMillan and Woodruff, 2000), we examine responses relating to a firm's most recent payment dispute with a customer to explore why some disputes end up in the courts while others do not, why some claimants eventually receive a greater percentage of the amount in question, and why some relationships survive in the aftermath.<sup>3</sup> An expected cost-benefit calculus is presumed to guide behavior at each of these several stages in the wake of an inter-firm dispute. The resolution method selected, for example, should depend upon the opportunity cost of going to court. And the mutual desire to continue transacting after a dispute has ended should be determined by firms' *ex post* evaluation of the relationship's value. This general approach leads to the identification of behavioral correlates at the firm, relationship and macro-institutional levels.

Inspired by the economics research chronicling the development of enforcement mechanisms through history, particular attention is given to the roles played by both geography and institutions for inter-firm information exchange (North, 1990). An important theme from this literature is that the enforcement mechanisms that evolve to support arms-length transacting are sensitive to the geographic expanse of the market. Greater distances between parties give rise to greater transaction costs, which can be attenuated by non-public institutions that operate on the basis of reputational sanctions. Greif (1993), for instance, demonstrates how the rich flow of information among dispersed Maghribi traders reduced the risk associated with trade between Mediterranean Sea ports in the eleventh century. And Milgrom *et al.* (1990) show how the Champagne Fairs of medieval times developed

mechanisms to centralize records of traders' transactional histories, thereby discouraging breach of contract and allowing for identification of reliable partners from distant locales. One contemporary analog to these historical institutions is a business association, a non-commercial organization designed to promote the general interests of members. Such associations may support the expansion of markets by improving relational contracting, which can be particularly valuable in environments with under-developed public institutions for contract enforcement (Doner and Schneider, 2000; Woodruff, 1998).

The evidence presented in this article confirms that geographic distance raises costs associated with experiencing a payment dispute. The likelihood of recovering a debt is shown to drop in the distance between trade partners, particularly if an international border intervenes. Moreover, the probability of a relationship surviving a dispute, thus diminishing the need to search for and screen new partners, declines with distance. These costs appear, however, to be mitigated by business associations, which, our evidence suggests, complement the formal legal system. Business association members are shown to recover a higher percentage of a disputed payment and are more likely to maintain a relationship in the aftermath of a disagreement. Though the mechanism through which associations reduce their members' dispute-related costs cannot be precisely identified, the evidence presented here is consistent with the proposition that associations play an important role promoting inter-firm flows of information and, thereby, assisting the development of markets.

The article is structured as follows. Section 2 reviews the relevant literature on inter-firm payment disputes, the post-socialist transition and business associations. In the third section, the data for analyzing the evolution of payment disputes are presented. Sections 4 and 5 investigate the factors that affect, respectively, courts' involvement and the dispute's

costs – in terms of un-recovered payments and severed relationships – to the creditor. The final section presents conclusions.

## 2. Payment Disputes and the Post-Socialist Transition

It is common practice for suppliers not to require customers to pay in full either in advance or at the time of delivery. Instead, they offer trade credit in return for a promise to be compensated at a later date. In aggregate terms, these credits can add up to an impressive amount of commercial lending. Indeed, in a number of industrialized countries, the stock of trade credit (or accounts receivable) can amount to as much as 25% of firms' assets and 40% of GDP. As with loans of any type, suppliers offering trade credit assume a risk that they will not be fully paid off by the contracted date. It is, after all, not uncommon for customers to fall into arrears. As much as one half of the stock of trade credit in many countries is overdue at any one time (Rajan and Zingales, 1995).

Inter-firm payment disputes are particularly well suited for the purposes of cross-country analysis. For one, they tend to be relatively straightforward and easy to resolve since the contractual violation and, thus, injury to the creditor can generally be determined quickly and objectively (Djankov *et al.*, 2003).<sup>4</sup> For another, they are among the most common types of commercial disagreements across a range of historical and geographic contexts (Kagan, 1984). Indeed, during the early stages of the transition in Central and Eastern Europe (CEE), inter-firm payment disputes became a prominent feature of the economic landscape. Almost immediately after the fall of communist regimes and the dismantling of their managed economic systems, firms in the region began extending trade credit to one another. Almost as quickly, they confronted the problem of overdue payments. Survey evidence from the early 1990s shows that deliveries to firms that fell into arrears would generally be stopped

and that pre-payment was required from those for whom the capacity or willingness to pay at a later date was in doubt (Gray, 1997; Schaffer, 1998). In other words, firms took little time to learn the cost of unpaid bills and adapted their behavior accordingly. Payment arrears, they understood, were to be avoided.

When disputes have arisen, however, a good deal of research suggests that firms exploit a range of formal and informal mechanisms to resolve them. For instance, Hendley *et al.* (2000) argue that while the Russian court system is used more and to greater effect than popularly believed, commercial disputes are not resolved so much by third parties as they are by relational mechanisms. Some of these are bilateral and include firm-to-firm negotiations that may or may not be confrontational; others are multilateral and involve the claimant spreading (or threatening to spread) information to damage the offending firm's reputation. In subsequent articles, Hendley (2001, 2004a) argues that courts are more apt to be used to resolve payment disputes if the claimant is in a competitive market, shares a relatively short transactional history with the debtor and is not seeking a particularly large sum of money.

Research on the CEE countries also highlights the use of a diverse range of formal and informal strategies. Dietrich (2000), Schönfelder (2003) and Murrell (2001) confirm for Poland, Slovakia and Romania, respectively, that courts were used heavily in the 1990s to resolve commercial disputes. Johnson *et al.* (2002a) demonstrate that both firms' confidence in courts and their use of common modes of relational contracting correlate with a greater willingness to extend trade credit.<sup>5</sup> And Hendley and Murrell (2003) and Murrell (2003a) report that Romanian managers rank bilateral mechanisms and the legal system as the predominant means for supporting commercial agreements.

Despite apparent similarities, care should be taken in drawing comparisons between the CEE countries and Russia since comparative data suggest substantial differences in their institutional environments. In 1999, managers in a number of post-communist countries were asked whether at that time, as well as three years prior, their legal system upheld contract and property rights.<sup>6</sup> Whereas in Russia, only one-quarter of managers responded positively, in Poland, Romania and Slovakia, over half did (see Table 1).<sup>7</sup> Moreover, respondents in these three CEE countries described their courts as “fair and impartial,” “honest and uncorrupted,” “consistent and reliable” and “able to enforce decisions,” at roughly twice the rate of those in Russia.<sup>8</sup>

[TABLE 1]

The sharpness of this contrast diminishes with respect to perceptions of “quickness” and “affordability.”<sup>9</sup> Indeed, with respect to these measures, as well the capability to enforce decisions, there is some noteworthy variation within the three CEE countries, with Poland trailing the other two countries on each. Indeed, others have confirmed Polish weakness in these areas as well. With respect to enforcement problems and high costs, Dietrich (2000) both confirms the failings of the Polish bailiff system and concludes that relatively high filing fees had impeded access to the judicial system.<sup>10</sup> And Djankov *et al.* (2003) present more recent evidence that the backlog in the Polish court system remains among the highest in the region. It is not clear, however, whether these dimensions of court performance weigh more heavily than others on firms deciding to pursue a payment dispute in court.

In addition to demonstrating firms’ reliance on courts and relational mechanisms, published research has downplayed the role of private third parties in resolving disputes. Some researchers have highlighted the contract enforcement services of mafia groups

(Leitzel *et al.*, 1995; Varese, 2001). But comprehensive studies of dispute resolution have diminished their relative importance (Hendley *et al.*, 2000). In some non-transitional contexts, business associations have been shown to offer arbitration services and enhance relational contracting by collecting and disseminating information on firms' reliability (Doner and Schneider, 2000; Macaulay, 1963; Woodruff, 1998; World Bank, 2002). Although some evidence from Russia in the early 1990s suggests that they may have played such a role (Greif and Kandel, 1995; Recanatini and Ryterman, 2001), a number of subsequent studies from the CEE countries have minimized their contribution in this regard.<sup>11</sup> Indeed, existing evidence seems to confirm that associations play a relatively minor role in *directly* resolving disputes. Broadman *et al.* (2004) report that only 10% of association members in Romania are in an associations that play a major role in helping to resolve disputes. Schönfelder (2003) notes the surprisingly small caseload at the arbitration court established by the Slovak Chamber of Commerce and Industry, despite being staffed by highly qualified jurists. And Murrell (2003a) and Hendley and Murrell (2003) note the low ranking, relative to other mechanisms, given by Romanian managers to associations and business networks with respect to preventing or resolving disputes.

These studies, however, may be asking questions that reveal only a single dimension of business associations' influence on the evolution of commercial disputes. It seems clear that associations' impact, relative to other mechanisms, is minor with respect to directly resolving disputes. But their influence may be felt in other ways that may be less direct. Pyle (2005), for instance, shows that even when controlling for the degree of pre-existing communication with other firms, association members in five transition countries are more likely both to publicize their trade partners' transgressions and to learn about any disputes between their partners and other firms.<sup>12</sup> Associations, that is, would seem to facilitate

information sharing in a manner that, at a minimum, grants members access to a mechanism for imposing reputational sanctions. Such a mechanism could well have an impact on the evolution of payment disputes even if business associations themselves seldom provide the venue or contribute the services to resolve disputes directly.

Before proceeding with a discussion of the data to be used in our analysis, we should note that most of the research on the behavior of parties to disputes concentrates on the institutional mechanism(s) chosen for their resolution. Subsequent outcomes, in terms of recovery of damages and the endurance of the relationship, have not been well studied. Data on “enforceability,” such as that presented in Table 1, provide some sense of how successful firms will be in realizing court judgments, but careful studies of enforcement institutions and recovery rates are rare. Kahn (2002), Schönfelder (2003) and Dietrich (2000) describe the strength of bailiff powers in Russia, Slovakia and Poland, respectively. Hendley (2004b), however, stands out for tracking enforcement in specific court-adjudicated disputes, concluding from a sample of 100 cases in the Russian courts that roughly two-thirds of creditors recover some or all of the disputed amount.

### **3. Data**

In 1997, the European Bank for Reconstruction and Development sponsored a survey designed to study the barriers to small and medium-sized enterprise development in transition countries. Roughly one thousand manufacturing firms in Poland, Slovakia and Romania participated.<sup>13</sup> The lead investigators generated several noteworthy papers before placing the data in the public domain (Johnson, Kaufmann, McMillan and Woodruff, 2000; Johnson *et al.*, 2002a; Johnson *et al.*, 2002b).

In general, the average firm in the survey does not vary greatly across the countries. As shown in Table 2, it operates with slightly under a hundred employees and faces a not insignificant amount of competition. Most of the firms are owned privately by nationals of the country in which they are located; indeed, no more than five percent of the respondents have in excess of one-quarter state or foreign ownership. On average, they have a fair amount of turnover in their customer base, with roughly one-fifth of customers being new in the past year. Roughly a third of the firms report membership in a business association. And solid majorities were profitable in 1996.

[TABLE 2]

The EBRD survey addressed both experience with standard contracting problems as well as general attitudes toward mechanisms for enforcing agreements and resolving disputes. As shown in Table 3, over three-quarters of respondents had had a customer fail to pay for a product after delivery. And roughly one-quarter had had problems with a supplier that refused either to accept the return of defective merchandise or to provide monetary compensation. We should bear in mind that the quality of a country's institutions may have an ambiguous relationship to the way in which such questions are answered (Bigsten *et al.*, 2000). An effective court system, on the one hand, may deter opportunistic breach of contract in which case we would expect an inverse relationship between the incidence of disputes and the effectiveness of legal institutions. On the other hand, a more effective legal system may embolden firms to engage in transactions that might otherwise have been avoided; for instance, they may more willingly extend trade credit to a new customer.

Perhaps a better indicator of the effectiveness of a country's legal system is the degree to which courts are considered capable of upholding laws and supporting private

contracts. Over three-quarters of surveyed firms in these three countries report that the court system can enforce an agreement with a business partner.<sup>14</sup> Alternative mechanisms were not considered nearly as viable. Only in Slovakia do we observe a response rate exceeding 10% for any mechanism other than the courts; the 12.7% recorded by “other” there may reflect the lingering role of privatized enforcement (*i.e.*, “tough guys [with] baseball bats”) noted in Schönfelder’s (2003) discussion of debt collection. Indeed, relative to other public institutions as well as private contract enforcers, the data suggest that the courts in the region have established themselves as the most widely trusted third party for enforcing business agreements. Business associations, whether conceived of as coincident with or a subset of “non-governmental organization” and/or “other,” are not widely regarded as an institution that can explicitly enforce a commercial contract. It is also important to note that a non-trivial percentage, roughly one-sixth of those surveyed, do not consider any institution capable of fulfilling this roll. A similar fraction reports never having appealed to a third party for the resolution of a dispute.

The pattern of cross-country variation here is a bit surprising. Notably Poland, which by some accounts (including some of the data presented in Table 1) has the region’s most sophisticated legal system (Ramasaby, 2002), has a relatively high percentage of firms that express no confidence in its ability to enforce contracts. Romania, however, which by some measures has lagged in terms of institutional development (Ramasaby, 2002), has courts that rate higher in terms of enforcement capability. This relationship, in part, may be explained by the reputedly quicker development of institutions in Transylvania relative to the rest of Romania (Murrell, 2001).<sup>15</sup> But it also seems to be picking up the relative ranking of the “ability to enforce decisions” provided in Table 1. Poland, as was noted above, despite having developed relatively sophisticated courts, struggled in the 1990s with creating

supplementary institutions, such as strong and motivated bailiffs, to enforce their rulings (Dietrich, 2000).

[TABLE 3]

In addition to these general responses regarding their history with commercial disputes and their trust in and use of various enforcement mechanisms, survey respondents answered questions specifically related to the most recent payment dispute in which they were involved. We are thus able to assess the firm-level and relationship-specific correlates of how particular disputes evolve in a well-defined context. For the sake of standardization, we focus exclusively on those disputes that occurred in the two-and-a-half-year period prior to the survey, meaning that we drop from the analysis those firms whose most recent dispute occurred before 1995. Moreover, we exclude firms who report on a payment disagreement with a supplier.

Considering the large sample size, we have at our disposal a good deal of information about the respondent, the trade partner and their interaction. The summary data for the disputes, broken down by country, are presented in Table 4A.<sup>16</sup> As we observe, roughly 80% of disputes occurred with private enterprises. Roughly 60% occurred with partners located in or close to the same city as the respondent, while just over 5% were with firms located in other countries. On average, the firms involved had been business partners for eighteen months. We should note here that we do not have information on the monetary amount involved in the dispute. Since this may be related to behavior at successive stages of the dispute, we should be cautious in our interpretation of the regression results and evaluate them in light of a possible omitted variable bias.<sup>17</sup>

[TABLE 4A]

In each country, courts became involved in more than one-quarter but less than one-half of the reported disputes. In Poland, the rate of court use exceeded that in Romania by nearly a factor of two, a finding consistent with the relative assessments of legal experts (Ramasasty, 2002) and managers (see Table 1) regarding the countries' courts' ability to uphold contract rights in business disputes. Firms in the region most frequently reported not having involved any third party, public or private, to resolve the dispute – a finding similar to that of a seminal study on contractual relations in the United States (Macaulay, 1963). Only a very small minority report having used private agencies, either alone or in conjunction with the courts.

In roughly one-sixth of the cases, the dispute concluded with respondents collecting nothing and writing off the customer's debt completely. The comparatively high rate of write offs in Poland may be a reflection of the enforcement problems in the court system noted above. Half of the disputes across the three countries ended with a partial recovery. And in the remainder, the respondents recovered the full amount that they were owed. Finally, we observe that business partnerships survived a payment dispute in roughly one-third of the cases, with the rates in Slovakia and Romania measuring roughly twice that in Poland. The reasons for all these relationships may be clarified in the subsequent multivariate analysis.

#### **4. Litigation**

A payment dispute may be thought of as a multi-stage process that may or may not proceed through the court system (Felstiner *et al.*, 1980-81; Hendley *et al.*, 2000; Hendley, 2001). After failing to receive payment in the contracted time frame, the seller will, almost always, make an appeal to the delinquent party.<sup>18</sup> The nature of this exchange can vary greatly. The seller can provide gentle reminders or make menacing threats; or the two parties

may immediately enter negotiations to work out a new repayment schedule; or they may find some other alternative, but mutually satisfactory, resolution. The seller might also choose to involve other private parties somehow, either to exert pressure on the buyer or to assist in some other way to resolve the dispute. For instance, the seller may damage the buyer's reputation by spreading information about the problem among other firms. Alternatively, private dispute resolution institutions could be called upon to provide mediation services. Whatever the exact mechanism, this preliminary step is distinguished by communications that remain outside of publicly sponsored channels.

Purely private mechanisms, however, may not produce a satisfactory outcome from the seller's standpoint. If this is the case, the grievance will either be dropped or transformed into a legal claim in which case the public court system will be asked to render a judgment. As a general rule, few business disputes actually end up in litigation. Most conclude at an earlier stage with the two parties reaching a mutually satisfactory agreement or the aggrieved dropping the claim. This is as true for countries with mature public institutions (Cooter and Rubinfeld, 1989; Macaulay, 1963; Macaulay, 1977) as for those without them (Bigsten *et al.*, 2000; Hendley, 2001 and 2004a). After all, the costs of going to court are rarely trivial. Often, these costs provide the disputants with good reason to find alternative ways to resolve their differences. In addition to explicit monetary outlays, which may include lawyers' bills and filing fees, the commitment of time to a court case can divert resources from a firm's core, income-generating activities (Priest and Klein, 1984). Indeed, the simplest commercial cases, like the recovery of a bounced check, can take several months to resolve even in well-functioning institutional environments (Djankov, *et al.*, 2003).

Additionally, a dispute may be kept out of the courts because of a lack of faith in the legal system's effectiveness. Judges, for instance, may lack the expertise and experience to

reach suitable decisions, thus making the outcome of litigation less predictable (Dietrich, 2000). Or they might be prone to capture by powerful actors (Broadman *et al.*, 2004; Hellman *et al.*, 2003; Dietrich, 2000). Or courts simply may be ill equipped to enforce their rulings. As we observed already, such doubts in the legal system are not altogether uncommon in the post-socialist context.

Given the discussion to this point, we would expect that the decision to take a dispute to court would hinge upon the macro-institutional environment – most notably, the effectiveness and accessibility of the court system. But the cost-benefit calculus, however, is just as likely to be influenced by more micro-level factors. The same firm may find different mechanisms preferable in different circumstances depending upon the characteristics of the other party and the nature of their shared relationship. For instance, since mutual goodwill and trust can often only develop in a relationship with time, longer-term business partners may have a greater capacity to cooperate and thus be more likely to settle disagreements amicably and outside of court (Macaulay, 1963; Hendley, 2004a).

Geographic distance between trade partners may also influence the decision to resolve a dispute through the court system. Trans-national discontinuities in legal systems, for instance, may make a supplier less likely to file suit against a delinquent customer based in another country (Anderson and Marcouiller, 2002; Anderson and van Wincoop, 2004; Rodrik, 2000). Local courts may be unwilling and international courts unable to enforce agreements reached between firms from different countries. Indeed, the survey data in Table 4B show that payment disputes with foreign customers have been less likely to be resolved through the court system.

[TABLE 4B]

Inside a single country, however, we have less in the way of theory or prior research to guide the generation of hypotheses. If intra-country jurisdictional boundaries raise the expected costs of enforcement, it might be natural to suspect that disincentives to litigate decrease with the distance between firms.<sup>19</sup> On the other hand, the closer two parties are in relationship to one another, the greater the potential role of alternative relational mechanisms for resolving disputes (North, 1990). With geographic proximity, that is, face-to-face negotiations may be less costly and reputational sanctions may carry greater weight. Thus, all else equal, the relative value of public mechanisms will not be as great. In Table 4B, we observe that courts are more apt to be involved when disputants are in the same country but not from the same city. This is consistent with the proposition noted above that trade partners in close proximity to one another have a richer array of options for resolving a dispute.

As we have noted above, business associations have been shown to provide the basis for relational contracting in transition countries by giving members access to a network of firms through which the behavioral histories of their trade partners can be transmitted. Pyle (2005) shows that the relative importance of business associations in channeling inter-firm information flows is greater when the offending and the aggrieved parties are located in different regions. Given their role in providing informational services that can potentially substitute for the legal system, we might expect membership in a business association to be negatively associated with taking a dispute to court (World Bank, 2002). On the other hand, business associations have been known to disseminate information about the legal system to their constituents (Doner and Schneider, 2000). In a rapidly changing institutional environment, there may well be economies (especially, to small and medium-sized enterprises) to a collectively sponsored organization that offers constituents legal consulting

services. Indeed, both anecdotal and survey evidence suggest that business associations in post-socialist countries do serve exactly this function.<sup>20</sup> If this is the case, then business association membership, all else equal, may be positively associated with use of the courts. Moreover, Frye (2002) has shown with Russian data that firms belonging to business associations are more successful in influencing legislation, particularly at the regional and local levels. Such influence may well extend to commercial courts. Indeed, Hellman *et al.* (2003) report that roughly one-fifth of firms believe that the sale of court decisions in Poland, Romania and Slovakia has a “significant or very significant impact on their business.” Given all these considerations, it is not clear *ex ante* whether business association membership should positively or negatively influence the decision to take a dispute to court.

[TABLE 4C]

Larger firms may be more willing to absorb the fixed costs associated with bringing a case to court (Broadman *et al.*, 2004).<sup>21</sup> There is evidence, for instance, that the rapidly changing legal environment of the transition is more burdensome for smaller enterprises that do not have in-house counsel or have fewer resources with which to “capture” judges (Broadman *et al.*, 2004; Dietrich, 2000; Hellman *et al.*, 2003). What is more, state ownership may increase the probability that a firm receives a favorable hearing and, with it, the attractiveness of going to court (Broadman *et al.*, 2004).<sup>22</sup> And it has been argued in developing countries that older firms possess greater familiarity with, and thus a greater disposition to use, formal legal institutions (Bigsten *et al.*, 2000). However, it is not inconceivable that age, as well, brings greater appreciation for informal resolution mechanisms. Some, that is, have suggested that the primary beneficiaries of well-functioning courts are newer firms whose managers may not have well-established business or social

connections and thus may find it more difficult to settle out of court (Hendley *et al.*, 1997; McMillan and Woodruff, 1999a; McMillan and Woodruff, 1999b).

On the basis of case study evidence from Russia, Hendley (2001) argues that a high degree of customer turnover correlates with greater rates of litigation since the cost of damaging a relationship through litigation is less if the search costs for new customers are comparatively low.<sup>23</sup> Moreover, it is possible that a firm taking on more new customers may receive greater value from a reputation as a tough bargainer and would, thus, be more likely to take disputes to court (Farmer and Pecorino, 1998).

The legal studies literature suggests several other potential firm-specific correlates of choosing to litigate a commercial dispute. Cheit and Gersen (2000) note that firms in expanding industries are less likely to use the courts because the short-term value of winning a case will be relatively smaller when compared to the returns on resources invested elsewhere. Although, this conclusion was reached on the basis of sector-level evidence, the same logic of opportunity costs could be applied to individual enterprises. That is, investing time and money in litigation will be more costly for firms whose core business is generating a higher return. And Kenworthy *et al.* (1996) argue that lower rates of market concentration are associated with lower rates of litigation. Firms that face a number of competitors will be more likely to litigate since they “can less easily afford to forgo opportunities for immediate gain, and their room for maneuver, and ability to sustain the cost of constructing and applying alternative sanctions are reduced.”

Considering our discussion to this point, we now explore the determinants of using the court system to resolve a dispute in the following probit regression:

$$\Pr(y_i=1) = \Pr(\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i + \epsilon_i > 0) = \Phi(\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i), \quad (1)$$

where  $y_i = 1$  if the dispute went before the courts;<sup>24</sup>  $F_i$  represents a vector of firm-specific variables, which include the creditor's membership in a business association;  $R_i$  is a vector of variables describing the characteristics of the relationship between the respondent and the customer, which include their geographic proximity;  $M_i$  represents a vector of macro-level variables, which include country and year-of-dispute controls; and  $\Phi(\bullet)$  is the normal cumulative distribution function.<sup>25</sup>

Table 5A presents evidence that the use of courts to resolve payment disputes is a function of both the respondent's membership in a business association and the geographic relationship between itself and the offending client.<sup>26</sup> In the specification presented in column 1, we observe that relative to the instance in which the delinquent customer is located in the same city, a firm is roughly thirteen percentage points more likely to take a dispute to court if the defendant is located near, but not in, the same city. This relationship is shown to be even stronger when we restrict the disputes just to the subset that comprises parties that are located either in the same city or are otherwise relatively close to each other (see column 3).

Column 2 reveals that relative to a customer located in the same city, the likelihood of taking a delinquent client to court is fifteen percentage points greater if that client is located elsewhere in the country. However, this is only the case if the respondent is not a member of a business association. In light of earlier research suggesting that business associations in transition countries enhance existing relational information flows with respect to non-local, domestic clients (Pyle, 2005), column 2 adds an interaction term to the base regression in column 1. This new variable takes on the value of one if the respondent is a member of a business association whose most recent payment dispute occurred with a firm

located in the same country but in a region other than the respondent's. By its inclusion, we are presented with evidence suggesting that for non-association members, greater distance between disputants within the same country is associated with an increased probability of taking a dispute to court. But for association members, a problematic client located outside one's locale is no more likely to be taken to court than one located in one's locale. The negative and statistically significant association of the interaction term and litigating the dispute roughly cancels out the direct effect of the client being "located elsewhere in the country." This evidence thus provides support for the proposition that business associations offer services that substitute for the court system with respect to distant, domestic relationships.

However, with respect to a dispute occurring between firms located in the same region (*i.e.*, the two are in the same city or are otherwise close by), the evidence suggests that associations may actually complement the formal legal system (see column 3). Association members, that is, are roughly fifteen percentage points more likely to use the courts – an association that is significant at the 5% level. This finding contradicts the conventional wisdom that, with respect to contract disputes, business organizations provide services that solely substitute for public enforcement mechanisms (World Bank, 2002). How might this then be explained?

Since we already possess evidence that associations contribute to inter-firm information flows regarding contract violators (Macaulay, 1963; Doner and Schneider, 2000; Pyle, 2005; Woodruff, 1998), it is reasonable to suppose that they also enhance other types of information dissemination, including information regarding how to access and effectively utilize the court system. Indeed, as we noted above, both anecdotal and survey evidence from the region suggests that this is the case. An alternative explanation for the positive

association between membership in a business organization and use of the courts could be that associations facilitate unjust influence over the legal process. Although our data do not allow us to definitively eliminate this explanation, we should note that our sample is not composed of those types of enterprises that have been shown capable of successfully influencing public actors in post-socialist countries – *i.e.*, large, state-owned firms with a significant degree of market power (Hellman *et al.*, 2003).<sup>27</sup> Rather, the sample here is made up of small and medium-sized private enterprises that face substantial competition.

The evidence that greater distance between disputants raises the demand for court-supplied dispute resolution, *ceteris paribus*, is consistent with the suggestion of North (1990) that outside localized settings, the relative value of more informal contracting mechanisms falls. Certain types of relational contracting weaken across geographic space; periodic hounding of delinquent clients, for instance, may be a more costly or less effective strategy if they are in another town. The relationship between distance and use of courts, however, does not apply to disputes across national boundaries. International borders clearly diminish the net benefits associated with court-based contract enforcement (Anderson and Marcouiller, 2002; Anderson and van Wincoop, 2004; Rodrik, 2000).

With respect to other firm-level characteristics, we observe that larger firms are much more likely to use the court system to resolve disputes, a result that mirrors findings from a recent study of African manufacturers (Bigsten *et al.*, 2000). We also observe that controlling for the overall size of a firm's customer base, having a larger number of new clients makes a firm more likely to resolve a dispute through the court system. To the extent that a newer customer is more apt to be influenced by a signal of a “willingness to go to court,” the value of the signal will be greater the larger the number of new customers. The positive association here could also be explained by the lesser value attached to specific

relationships, and thus less interest in working toward a cooperative solution, when new customers are easily found. Litigation, that is, may be less costly to suppliers who have an easier time finding clients.

Finally, we should also note the macro-level effects suggested by the coefficients on the country variables.<sup>28</sup> Controlling for firm and bilateral relationship characteristics, firms in Romania are less likely to rely upon the court system to resolve a dispute than are firms in Poland. We should be careful, however, not to be too quick to read into this result a confirmation of the relative rankings of legal system effectiveness highlighted earlier. There are many dimensions of court performance that matter for doing business and superior performance in one is often not reflected in others. Polish courts, although trusted for their ability to uphold contract rights in business disputes (see Table 1), have struggled with delays and are also known for being more costly than others in the region (World Bank, 2004). In addition, it is possible that the coefficients on the country variables reflect macro-institutional differences unrelated to the court system. Difficult-to-measure variation in social capital, for example, may explain the relative appeal of non-litigious solutions.

## **5. Debt Recovery and Relationship Survival**

The selection of the resolution mechanism does not put an end to matters. A court finding that the defendant is obligated to pay or a private agreement establishing a repayment schedule brings the dispute into the settlement phase. The seller then either passively awaits repayment or actively pursues the buyer through informal or formal means. Finally, after the settlement has been implemented, the two parties decide whether to maintain their relationship. Although a decision to terminate it need not relate directly to the

dispute, it is entirely possible that the seller no longer finds the buyer trustworthy or that the two no longer share the mutual goodwill necessary to engage in future transactions.

The determinants of the transaction costs related to the incomplete recovery of a debt and the potential need to search for and screen new partners have received almost no attention in the economics literature. However, it is not unreasonable to believe that they affect the firm-level calculus as to the costs of doing business when the probability of a dispute is not insignificant. From the perspective of a firm that may be in the position of being a claimant in a future payment dispute, the greater the perceived probability that such disputes can be resolved successfully and amicably, the less threat they pose to the expansion of market relations. If monies owed can eventually be recovered and/or if the search costs for new partners (associated with a severed relationship) can be avoided, the expected costs of a dispute will be less and firms will be emboldened to enter a wider array of arms-length transactions.

### **5.1 Debt Recovery**

As with the selection of the appropriate mechanism to resolve the dispute, we anticipate that the recovery of the amounts owed will be influenced by both the geography of the relationship and the supplier's access to mechanisms for relational contracting. Specifically, we anticipate that greater geographic distance between parties will decrease the percentage of the disputed amount that is recovered. With increased distance, the supplier's costs of collecting a fixed amount are likely to rise. And the customer's costs of renegeing, specifically with respect to reputational damage, are likely to fall. Indeed, this relationship between the degree of payment recovery and geographic distance initially appears to be confirmed by evidence presented in Table 4B. Relative to a debtor abroad, nearly twice the

share of arrears are paid off in full when the customer is located in the same city. And for firms located somewhere outside the city of the respondent, the rate of complete write offs is roughly twice that for local debtors.

We would also expect that if business associations do provide informational and consulting services that help resolve disputes, the members' ability to recover debts should, *ceteris paribus*, be superior to non-members. And indeed, in Table 4C, we observe that members are more apt to recover their loss in full and less apt to write off the debt completely.

In addition to the geographic and institutional determinants of the degree of payment recovery, it is not unreasonable to hypothesize that the variables presumed to be associated with litigating a dispute would affect the willingness and ability of a claimant to recover an unpaid debt. We thus explore the effects of its size, age, ownership type, recent financial success as well as the nature of the market in which it operates; on the customer's side, we explore the impact of its ownership type and the length of its relationship with the claimant. In short, we expect that both the supplier's effort and ability to recover the payment and the customer's willingness and ability to settle the matter amicably will depend on firm and relationship-specific characteristics, macro-institutional variables, and lastly, the mechanism chosen to resolve the dispute. The inclusion of a dummy variable for whether or not the dispute had been taken to court is likely to be a good proxy for the dispute's severity (Macauley, 1977; Williamson, 1996).

Considering our discussion to this point, we estimate the following in an ordered probit framework:

$$\Pr(y_i=1) = \Phi(-(\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i + \beta_4 E_i)), \quad (2a)$$

$$\Pr(y_i=2) = \Phi(\theta_1 - (\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i + \beta_4 E_i)) - \Phi(-(\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i + \beta_4 E_i)), \quad (2b)$$

$$\Pr(y_i=3) = 1 - \Phi(\theta_1 - (\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i + \beta_4 E_i)), \quad (2c)$$

where  $y_i=1$  if the debt was written off completely,  $y_i=2$  if the debt was recovered in part, and  $y_i=3$  if the debt was recovered in full;  $F_i$  represents a vector of firm-specific variables;  $R_i$  is a vector of variables describing the characteristics of the relationship between the respondent and the customer;  $M_i$  represents a vector of macro-level variables, which include country and year-of-dispute controls; and  $E_i$  is a vector of variables capturing the evolution of the dispute to this stage (*i.e.*, a control for whether or not it was taken to court);  $\theta_1$  (with  $\theta_1 > 0$ ) is a threshold value for an unobserved latent variable measuring the respondent's willingness and ability to recover the amount due; and  $\Phi(\bullet)$  is the normal cumulative distribution function.

Table 5B presents evidence that the degree of payment recovery is a function of both the respondent's membership in a formal business network and the geographic relationship between itself and the offending client. Regardless of whether we consider the full sample or the sub-sample of intra-country disputes, we observe that business association members are more likely to receive a larger share of the debt owed by a customer.<sup>29</sup> Business association members are roughly ten percentage points more likely to be compensated in full and six percentage points less likely to write off the debts completely; both effects are significant at the 5% level.

Several mechanisms could explain this positive association between business association membership and the degree of payment recovery. First, some associations enhance existing informal flows of information among firms and thus provide constituents with a mechanism that enhances reputation-based sanctions, which may increase customers'

incentive to re-pay (Pyle, 2005). Second, some associations provide advice as to what constitutes best practices regarding dispute resolution that may raise the net returns from efforts to reach a favorable settlement. In both respects, business organizations can be thought of as serving as nodes within a network of firms, collecting and disseminating information produced by members' experiences.<sup>30</sup>

As noted earlier, a potential alternative to the association as informational node explanation is the association as influence peddler. Because business association members in the post-socialist world have been shown to have greater influence than non-members over public institutions (Frye, 2002), we include a control for the interaction of association membership and the dispute having been taken to the court (see columns 3 and 4).<sup>31</sup> If the positive association between payment recovery and membership in a business organization is due to members' undue influence over court decisions, we might expect the sign on this interaction term to be positive and significant and, possibly, the coefficient on the business association dummy to lose its statistical significance. However, columns 3 and 4 do not offer support for this political leverage explanation.<sup>32</sup> The interaction term is not associated with payment recovery in a statistically significant manner and the coefficient on the association dummy variable remains positive and statistically significant. That is, association members whose disputes were not taken to court recovered their debts with success roughly equal to those that litigated.<sup>33</sup>

Relative to disputes with foreigners, claimants seeking to settle debts with other firms in their country are much more likely to be successful. For instance, relative to a dispute with a firm abroad, a claimant whose client is in the same city is nineteen percentage points less likely to write off a debt completely and 37 percentage points more likely to be

fully compensated – with both effects significant at the 1% level. This finding confirms earlier work suggesting that the costs of contract enforcement are an important component of the “border effects” that underlie the sub-optimal volume of trade flows (Anderson and Marcouiller, 2002; Anderson and van Wincoop, 2004). Although the relative effects of distance are less pronounced within a country, we do observe that relative to a client located “elsewhere” in the same country, a client located close to or in the same city is more likely to recover the debt, although these effects are not statistically significant.

In addition to the geographic and business institution effects, we observe that firms that are more than one-quarter owned by the state have more success in recovering their debts.<sup>34</sup> Less profitable firms, moreover, are more likely to receive a greater percentage of a disputed payment. What perhaps initially seems counter-intuitive can perhaps best be understood as a function of the opportunity cost of diverting time and other scarce resources away from profit generating activities to debt collection efforts, the outcome of which may be highly uncertain (Cheit and Gersen, 2000; Priest and Klein, 1984).<sup>35</sup> Lastly, as noted above, we should not infer too much from the coefficients on the country dummies. However, it is certainly worth noting that controlling for firm and relationship characteristics, firms in Romania seem to have notably more success than those in Poland in recovering disputed payments, a result that would appear to be consistent with the relative rankings of court enforcement capability provided in Tables 1 and 3; these expectations could impact recovery rates in non-court-adjudicated cases as well.

## **5.2 Relationship Survival**

Over sixty percent of the respondents to the survey reported that they no longer did business with the offending client (see Table 4A). The dispute itself may have been

responsible by providing either firm (or both) with information about the other's intentions or capabilities, which then tipped the cost-benefit calculus in favor of termination.<sup>36</sup> The supplier, for instance, may have revised a prior belief about the client's ability and/or willingness to pay bills on time. New information need not have been generated, however, for the dispute to end the relationship. Simply by eroding their shared stock of goodwill and trust, the firms may have recognized that the costs of a continued relationship would outweigh the expected benefits.

Termination of the relationship may impose costs that the two firms might prefer to avoid. Resources potentially needed to search for and screen new trade partners, that is, could be deployed elsewhere. All else equal, a dispute that does not lead to a relationship's dissolution imposes less of a social cost. For this reason, in particular, we are interested in the relevant determinants of a relationship's durability. As above, we highlight the influence of both inter-firm distance and business association membership. With respect to the former, we presume that greater proximity of the parties increases the ease of reaching an amicable settlement, both because the costs of communication decline and because the mechanisms for community-based sanctioning strengthen. The potential impact of business association membership, however, is not altogether obvious. On the one hand, members of business associations may be more willing to give up on an existing relationship because an association's information services may reduce the search costs for a new client. On the other hand, associations may provide members with access to information and other resources that increase the probability of reaching an amicable settlement.

In addition to the geographic and institutional determinants, it is reasonable to believe that the cost to the two firms of terminating the relationship will be a function of the respective parties' outside options. The more competitors the supplier has, the lower the

cost to the client of severing the relationship; and the more potential clients the supplier has, the lower its cost of termination.

We thus estimate the following probit regression:

$$\Pr(y_i=1) = \Pr(\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i + \varepsilon_i > 0) = \Phi(\beta_0 + \beta_1 F_i + \beta_2 R_i + \beta_3 M_i + \beta_4 E_i), \quad (3)$$

where  $y_i = 1$  if the relationship endures;  $F_i$  represents a vector of firm-specific variables, which include controls for both firms' outside options and the respondent's membership in a business association;  $R_i$  is a vector of variables describing the characteristics of the relationship between the respondent and the customer, which include their geographic proximity;  $M_i$  represents a vector of macro-level variables, which include country and year-of-dispute controls; and  $E_i$  is a vector of variables capturing how the dispute has evolved – *i.e.*, whether or not it was taken to court as well as the degree to which the creditor was successful in recovering the money.

Business association membership, again, proves to be associated with behavior at a critical stage in the evolution of a commercial dispute. Table 5C demonstrates that when controlling for behaviors in previous stages, member suppliers are over ten percent more likely to continue transacting with customers with whom they had experienced a payment dispute. We can only speculate as to the mechanisms at work here. But given what we know about associations increasing the flow of relational information among firms, one possible explanation is that by having access to a network of firms (and the reputation-related penalties that it can impose), a supplier is more likely to face a compliant and cooperative client in repayment negotiations. As such, there is a decreased probability that the dispute erodes the goodwill shared between the firms.

Table 5C also demonstrates again geography's important role. In the sample with all disputes (see column 1), we observe that firms whose partners are located "elsewhere in the country" are fifteen percentage points less likely than those with local partners (*i.e.*, those that are based either in or near the city where the supplier is located) to maintain the relationship in the dispute's aftermath. In column 2, we see that this relationship appears to be driven by disputes that are decided in the courts. Court-mediated disputes with non-local firms located "elsewhere in the country" are nearly 27 percentage points more likely to end in the relationship's dissolution than those with local clients; this interaction effect is statistically significant at the 1% level.

In other noteworthy results, we observe that relationships are less likely to survive when the supplier faces more local competition. That is, when their clients have more outside options, the forces holding the relationship together will not be as strong. Moreover, state-owned customers that had fallen into arrears are more likely to be retained than their private counterparts, which perhaps again is evidence that within the context of a dispute, state actors bring resources to bear that others cannot.<sup>37</sup> We further observe that a higher degree of payment recovery is strongly and positively associated with the dispute not leading to the relationship's dissolution. Lastly, we should not overlook that controlling for characteristics at the firm and relationship levels, Polish firms appear more likely to terminate relationships than those in Slovakia and Romania. During the 1990s, Poland was often characterized as having created an environment that promoted new entry and competition. It is at least conceivable that the greater willingness to terminate relationships there reflects a greater number of outside options that the respondents have in a highly competitive environment.

## **6. Conclusion**

By focusing on firms in three CEE countries, we are able to observe responses to payment disputes at a critical stage of economic development. In the mid-1990s, many managers were in essence still learning about market-based exchange; and the lessons they would learn could be expected to have a lasting influence on the development of markets. If procedures for resolving disputes were viewed as excessively burdensome or if amicable settlements were considered uncommon, the fear of broken promises and bitter disputes could seriously impede the creation of new exchange relationships. But if disagreements could be resolved at little cost and in a mutually satisfactory manner, firms could be expected to widen the scope of their transactions with confidence.

The evidence presented here suggests that one important lesson learned in the early transition is that the costs associated with recovering an overdue debt increase if the debtor is located at a distance from oneself. The evidence also points to the conclusion that these costs can be mitigated by membership in a business association. These findings thus seem to confirm two important points that have been emphasized in the study of the development of markets through history: exchange across greater geographic distance gives rise to greater transaction costs; and non-public institutions often arise to reduce those costs (North 1990). What seems particularly noteworthy is that these findings hold up consistently across the successive stages of a payment dispute.

We conclude with several caveats. For one, it would not be prudent to conclude that business association activity in these countries is net welfare enhancing. We have no grounds, for example, to dismiss the rent-seeking concerns that have been expressed with respect to organized business (Olson, 1982). For another, it is unclear to what extent the results here are a function of the unique institutional environment of the post-socialist transition. And even among transition countries, the variation in institutional contexts such as exists

between the CEE countries and Russia, should make us careful about making generalizations. Lastly, there are many country-specific factors that undoubtedly influence the evolution of disputes whose impact cannot be investigated with the data at our disposal. Indeed, the significance of country effects across the successive stages of payment disputes suggests that there is much to be learned from careful comparative studies of their respective dispute resolution environments.

**Table 1. Firms' Beliefs about Courts and Legal System**

		Poland	Slovakia	Romania	Russia
<i>Upholds contract and property rights in business disputes (%)</i>	1999	76.0	64.5	56.8	26.9
	1996	69.4	60.2	51.9	25.1
<i>Associated with following qualities in resolving business disputes (%)</i>					
Fair and impartial		44.8	39.8	41.9	18.1
Honest and uncorrupted		43.9	30.9	30.4	15.2
Consistent and reliable		35.0	29.0	35.1	17.7
Able to enforce decisions		35.1	56.5	53.0	20.1
Quick		6.7	12.2	13.8	11.1
Affordable		7.8	50.0	46.7	43.4

**Table 2. Summary Data on Respondents**

	All	Poland	Slovakia	Romania
Employees	58.7	63.0	57.0	56.4
Customers	97.7	99.7	86.0	107.1
Customers new in past year	17.4	17.8	15.1	19.4
Like firms in same city	8.7	10.7	6.5	8.8
State owned (%)	4.9	7.3	2.3	5.3
Foreign owned (%)	3.7	3.6	6.2	1.3
Business association members (%)	34.7	28.9	31.5	44.2
Profits as percent of sales in 1996 (%)				
< 0%	7.9	4.8	18.2	1.3
0%	4.6	2.1	11.0	1.3
1 – 10%	47.7	54.6	50.3	39.1
11 – 20%	29.6	28.3	14.0	45.0
21 – 40%	9.5	9.9	6.5	11.9
> 40%	0.7	0.3	0.0	1.6

**Table 3. Enforcing Agreements and Resolving Disputes in Eastern Europe**

	All	Poland	Slovakia	Romania
<i>A customer has failed to pay for product after delivery (%)</i>	77.4	76.2	81.5	74.5
<i>Number of observations</i>	932	303	308	321
<i>A supplier has refused to accept return of defective merchandise or to refund money for merchandise returned because of low quality (%)</i>	29.9	18.5	37.3	33.4
<i>Number of observations</i>	931	303	308	320
<i>Who can enforce agreement with a business partner? (%)</i>				
Court	76.1	72.9	67.9	86.9
National or local government	4.2	2.7	9.4	1.2
Non-governmental organization	4.5	7.3	4.9	1.6
Other	8.9	8.6	12.7	5.6
No one	16.7	23.8	20.6	6.2
<i>Number of observations</i>	932	303	308	321
<i>Have you resolved contract disputes without third party involvement? (%)</i>				
Never	17.2	26.4	20.4	4.9
Sometimes (<25%)	17.0	13.9	21.1	15.9
Often (25% < and < 75%)	4.7	3.7	5.8	4.6
Almost always (>75%)	14.9	11.4	20.4	12.7
Always	46.2	44.7	32.3	62.0
<i>Number of observations</i>	851	273	294	284

**Table 4A. Most Recent Payment Dispute with Customer**

	All	Poland	Slovakia	Romania
<b><i>Ownership type of customer (%)</i></b>				
State (or mixed) enterprise	20.6	22.7	12.6	26.4
Private enterprise	79.4	77.4	87.4	73.6
<i>Number of observations</i>	573	181	191	201
<b><i>Location of customer (%)</i></b>				
In same city	35.4	38.4	25.8	41.8
Close to city	23.2	22.2	25.3	22.2
Elsewhere in country	36.3	36.2	39.7	33.0
Abroad	5.2	3.2	9.3	3.0
<i>Number of observations</i>	582	185	194	203
<b><i>Which organization(s) assisted? (%)</i></b>				
Court	36.2	48.6	33.7	27.6
Private (formal or informal) agency	4.3	6.9	5.4	1.0
Court and private agency	1.1	1.1	2.1	0.0
No one	58.4	43.4	58.8	71.4
<i>Number of observations</i>	558	175	187	196
<b><i>What was the final outcome? (%)</i></b>				
Wrote off debt completely	16.1	23.6	10.8	14.4
Negotiated partial settlement	49.3	48.3	62.7	37.8
Recovered loss in full	34.6	28.2	26.5	47.8
<i>Number of observations</i>	560	174	185	201
<b><i>Firm is still a customer (%)</i></b>				
<i>Number of observations</i>	580	185	192	203

**Table 4B. Most Recent Payment Dispute with Customer**

	Same city	Near, not in same city	Elsewhere in country	Abroad
<b>Which organization(s) assisted? (%)</b>				
Court	30.5	42.7	39.2	24.1
Private (formal or informal) agency	4.0	2.4	3.9	17.2
Court and private agency	0.5	2.4	0.5	3.5
No one	65.0	52.4	56.4	55.2
<i>Number of observations</i>	200	124	204	29
<b>What was the final outcome? (%)</b>				
Wrote off debt completely	10.8	19.4	16.4	35.7
Negotiated partial settlement	47.7	47.3	52.7	42.9
Recovered loss in full	41.5	33.3	30.9	21.4
<i>Number of observations</i>	195	129	207	28
<b>Firm is still a customer (%)</b>	62.3	62.2	66.4	53.3
<i>Number of observations</i>	204	135	211	30

**Table 4C. Most Recent Payment Dispute with Customer**

	Business association member	Not business association member
<b><i>Which organization(s) assisted? (%)</i></b>		
Court	38.7	34.8
Private (formal or informal) agency	2.8	5.2
Court and private agency	2.4	0.3
No one	56.1	59.7
<i>Number of observations</i>	212	345
<b><i>What was the final outcome? (%)</i></b>		
Wrote off debt completely	11.8	18.7
Negotiated partial settlement	47.2	50.4
Recovered loss in full	41.0	30.8
<i>Number of observations</i>	212	347
<b><i>Firm is still a customer (%)</i></b>	43.6	32.6
<i>Number of observations</i>	220	359

**Table 5A. Did Court Assist in Resolving Most Recent Payment Dispute with Customer**

	All disputes	All disputes	Disputants located close to or in same city
<b><i>Supplier characteristics</i></b>			
Member in business association	0.063 (1.24)	0.130** (2.13)	0.149** (2.22)
Log age	0.054 (1.22)	0.055 (1.25)	0.085 (1.46)
Log employees	0.053** (1.99)	0.054** (2.02)	0.053 (1.42)
> 25% state owned	0.131 (1.23)	0.122 (1.14)	0.062 (0.51)
> 25% foreign owned	-0.018 (0.15)	-0.020 (0.16)	-0.210 (1.44)
Log customers	0.005 (0.14)	0.006 (0.16)	0.011 (0.21)
Log customers new in past year	0.060* (1.69)	0.063* (1.78)	0.060 (1.14)
Log firms located in same city	0.004 (0.19)	0.004 (0.21)	-0.014 (0.50)
Profitability in previous year	-0.025 (0.94)	-0.027 (0.99)	-0.006 (0.16)
Slovakia	-0.037 (0.55)	-0.039 (0.58)	0.033 (0.36)
Romania	-0.174*** (2.89)	-0.162*** (2.66)	-0.166** (2.08)
Poland (omitted)			
<b><i>Relationship / customer characteristics</i></b>			
Located in same city (omitted)			
Located close but not in same city	0.130** (1.99)	0.131** (1.99)	0.155** (2.23)
Located elsewhere in country	0.076 (1.18)	0.156** (2.06)	
Located abroad	0.057 (0.41)	0.071 (0.51)	
Log months a customer	-0.010 (0.60)	-0.012 (0.74)	-0.047** (2.14)
State owned	-0.030 (0.49)	-0.034 (0.56)	-0.005 (0.06)
<b><i>Distance and institutional interaction</i></b>			
Located elsewhere x trade association membership		-0.166* (1.84)	
Sector of supplier control	Yes	Yes	Yes
Additional supplier controls	Yes	Yes	Yes
Year of dispute control	Yes	Yes	Yes
Prob > chi2	0.0000	0.0000	0.0000
Number of observations	504	504	301
Pseudo R-square	.1234	.1285	.2260

Notes: Marginal effects from the probit regression are reported; \* indicates 0.10 level, \*\* 0.05 level, \*\*\* 0.01 level.; absolute value of t-stats reported in parentheses.

**Table 5B. Degree of Payment Recovery (Zero, Partial or Full)**

	All disputes		Disputants in same country	
	Debt fully written off	Debt fully recovered	Debt fully written off	Debt fully recovered
<b><i>Supplier characteristics</i></b>				
Membership in business association	-.056** (2.30)	.097** (2.24)	-.050* (1.71)	.090* (1.67)
Log age	-.003 (0.11)	.004 (0.11)	-.001 (0.03)	.001 (0.03)
Log employees	.009 (0.61)	-.014 (0.60)	.011 (0.79)	-.019 (0.79)
> 25% state owned	-.087*** (2.59)	.202* (1.84)	-.074** (2.20)	.176 (1.64)
> 25% foreign owned	.022 (0.31)	-.034 (0.33)	.030 (0.41)	-.049 (0.45)
Log customers	-.048*** (2.60)	.080** 2.54	-.044** (2.47)	.079** 2.41
Log customers new in past year	.049*** (2.72)	-.082*** (2.69)	.045** (2.53)	-.080** (2.51)
Log firms located in same city	.005 (0.52)	-.009 (0.52)	.008 (0.75)	-.013 (0.75)
Profitability in previous year	.041*** (3.23)	-.069*** (3.17)	.039*** (3.10)	-.069*** (3.05)
Slovakia	-.021 (0.60)	.036 (0.59)	-.002 (0.06)	.003 (0.06)
Romania	-.083*** (2.72)	.148*** (2.56)	-.075** (2.49)	.141** (2.41)
Poland (omitted)				
<b><i>Relationship / customer characteristics</i></b>				
Located in same city as supplier	-.190*** (3.47)	.369*** (3.24)	-.044 (1.48)	.081 (1.43)
Located close to but not in same city	-.144*** (3.37)	.320*** (2.66)	-.020 (0.68)	.037 (0.65)
Located elsewhere	-.145*** (2.63)	.276** (2.41)		
Located abroad				
Log months a customer	-.008 (1.01)	.014 (1.02)	-.006 (0.77)	.011 (0.77)
State owned	-.021 (0.71)	.036 (0.68)	-.017 (0.60)	.031 (0.58)
<b><i>Evolution of dispute</i></b>				
Did court help resolve	.117*** (3.70)	-.174*** (4.30)	.139*** (3.38)	-.215*** (3.95)
Did court help resolve x trade association membership			-.040 (0.99)	.078 (0.89)
Sector of supplier control	Yes		Yes	
Additional supplier controls	Yes		Yes	
Year of dispute control	Yes		Yes	
Prob > chi2	0.0000		0.0000	
Number of observations	490		465	
Pseudo R-square	.0814		.0772	

Notes: Marginal effects from the ordered probit regression are reported but only for the “extreme” outcomes; due to small number of observations in some sectors, three of ten combined to allow STATA to compute marginal effects for the ordered probit; \* indicates 0.10 level, \*\* 0.05 level, \*\*\* 0.01 level; absolute value of t-stats reported in parentheses.

**Table 5C. Relationship Maintained after the Dispute**

	All disputes	Disputants located in same country
<b><i>Supplier characteristics</i></b>		
Membership in business association	0.103*	0.104*
	(1.92)	(1.96)
Log age	-0.027	-0.037
	(0.55)	(0.73)
Log employees	0.033	0.026
	(1.13)	(0.92)
> 25% state owned	0.052	0.075
	(0.42)	(0.60)
> 25% foreign owned	0.113	0.089
	(0.91)	(0.65)
Log customers	0.022	0.032
	(0.58)	(0.83)
Log customers new in past year	-0.029	-0.037
	(0.80)	(0.98)
Log firms located in same city	-0.042*	-0.046**
	(1.83)	(2.05)
Profitability in previous year	0.042	0.050*
	(1.45)	(1.71)
Slovakia	0.204***	0.196***
	(2.83)	(2.60)
Romania	0.141	.117
	(2.06)	(1.71)
Poland (omitted)		
<b><i>Relationship / customer characteristics</i></b>		
Located in or close to same city		
(omitted)		
Located elsewhere	-0.150***	-0.061
	(2.79)	(0.93)
Located abroad	0.203	
	(1.54)	
Log months a customer	-0.029*	-0.024
	(1.69)	(1.37)
State owned	0.165**	0.148**
	(2.54)	(2.32)
<b><i>Distance and institutional interaction</i></b>		
Located elsewhere x court helped resolve		-0.267***
		(2.80)
<b><i>Evolution of dispute</i></b>		
Did court help resolve	-0.327***	-0.232***
	(6.32)	(3.44)
Degree to which payment recovered	0.131***	0.132***
	(3.60)	(3.58)
Sector of supplier control	Yes	Yes
Additional supplier controls	Yes	Yes
Year of dispute control	Yes	Yes
Prob > chi2	0.0000	0.0000
Number of observations	489	464
Pseudo R-square	.2612	.2692

Notes: Marginal effects from the probit regression are reported; (i) \* indicates 0.10 level, \*\* 0.05 level, \*\*\* 0.01 level.; absolute value of t-stats reported in parentheses.

### Sources Cited

- Anderson, James, Marcouiller, Douglas, 2002. Insecurity and the Pattern of Trade: An Empirical Investigation. *Review of Economics and Statistics* 84, 345-352.
- Anderson, James, van Wincoop, Eric, 2004. Trade Costs. *Journal of Economic Literature* 42, 691-751.
- Bigsten, Arne, Collier, Paul, Dercon, Stefan, Fafchamps, Marcel, Gauthier, Bernard, Gunning, Jan W., Oduro, Abena, Oostendorp, Remco, Patillo, Cathy, Soderbom, Mans, Teal, Francis, Zeufack, Albert, 2000. Contract Flexibility and Dispute Resolution in African Manufacturing. *Journal of Development Studies* 36, 1-37.
- Broadman, Harry, Anderson, James, Claessens, Constantijn, Ryterman, Randi, Slavova, Stefka, Vagleasindi, Maria, Vencellette, Gallina, 2004. Building Market Institutions in South Eastern Europe: Comparative Prospects for Investment and Private Sector Development. International Bank for Reconstruction and Development, Washington, DC.
- Cheit, Ross, Gersen, Jacob, 2000. When Businesses Sue Each Other: An Empirical Study of State Court Litigation. *Law and Social Inquiry* 25, 798-816.
- Cooter, Robert, Rubinfeld, Daniel, 1989. Economic Analysis of Legal Disputes and their Resolution. *Journal of Economic Literature* 27, 1067-1097.
- Dietrich, Mark, 2000. Legal and Judicial Reform in Central Europe and the Former Soviet Union: Voices from Five Countries. International Bank for Reconstruction and Development, Washington, DC.

- Djankov, Simeon, La Porta, Rafael, Lopez-de-Silanes, Florencio, Shleifer, Andrei, 2003. Courts. *Quarterly Journal of Economics* 118, 453-517.
- Doner, Richard and Schneider, Ben R., 2000. Business Associations and Economic Development: Why Some Associations Contribute More Than Others. *Business and Politics* 2, 261-288.
- Farmer, Amy, Pecorino, Paul, 1998. Frivolous Lawsuits and Fee Shifting in a Repeated Play Game. *International Review of Law and Economics* 18, 147-157.
- Felstiner, William L.F., Abel, Richard, Sarat, Austin, 1980-81. The Emergence and Transformation of Disputes: Naming, Blaming, Claiming. *Law and Society Review* 15, 631-654.
- Frye, Timothy, 2002. Capture or Exchange? Business Lobbying in Russia. *Europe-Asia Studies* 54, 1017-1036.
- Gelfer, Stanislaw, Martin Reiser and Katharina Pistor, 2000. Law and Finance in Transition Economies. *Economics of Transition* 8, 325-368.
- Gray, Cheryl, 1997. Creditors' Crucial Role in Corporate Governance. *Finance and Development* June, 29-32.
- Greif, Avner, 1993. Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders Coalition. *American Economic Review* 83, 525-548.
- Greif, Avner, Kandel, Eugene, 1995. Contract Enforcement Institutions. In Lazear, Ed, (Ed.), *Economic Transition in Eastern Europe and Russia*. Hoover Institution Press, Stanford, CA.

Hellman, Joel S., Jones, Geraint, Kaufmann, Daniel, 2003. Seize the State, Seize the Day: State Capture and Influence in Transition Economies. *Journal of Comparative Economics* 31, 751-773.

Hendley, Kathryn, 2001. Beyond the Tip of the Iceberg: Business Disputes in Russia. In: Murell, Peter, (Ed.), *Assessing the Value of Law in Transition Economies*. University of Michigan Press, Ann Arbor, pp. 20-55.

\_\_\_\_\_, 2004a. Business Litigation in the Transition: A Portrait of Debt Collection in Russia. *Law and Society Review* 38, 305-347.

\_\_\_\_\_, 2004b. Enforcing Judgments in Russian Economic Courts. *Post-Soviet Affairs* 20, 46-82.

Hendley, Kathryn, Murrell, Peter, 2003. Which Mechanisms Support the Fulfillment of Sales Agreements? Asking Decision-Makers in Firms. *Economics Letters* 78, 49-54.

Hendley, Kathryn, Ickes, Barry, Murrell, Peter, Ryterman, Randi, 1997. Observations on the Use of Law by Russian Enterprises. *Post-Soviet Affairs* 13, 19-41.

Hendley, Kathryn, Murrell, Peter, Ryterman, Randi, 2000. Law, Relationships and Private Enforcement: Transactional Strategies of Russian Enterprises. *Europe-Asia Studies* 52, 627-656.

Johnson, Simon, Kaufmann, Daniel, McMillan, John, Woodruff, Christopher, 2000. Why do Firms Hide? Bribes and Unofficial Activity After Communism. *Journal of Public Economics* 76, 495-520.

Johnson, Simon, McMillan, John, Woodruff, Christopher, 2002a. Courts and Relational Contracts. *Journal of Law, Economics and Organization* 18, 221-277.

- \_\_\_\_\_, 2000. Entrepreneurs and the Ordering of Institutional Reform. *Economics of Transition* 8, 1-36.
- \_\_\_\_\_, 2002b. Property Rights and Finance. *American Economic Review* 92, 1335-56.
- Kagan, Robert, 1984. The Routinization of Debt Collection: An Essay on Social Change and Conflict in the Courts. *Law and Society Review* 18, 323-371.
- Kahn, Peter, 2002. The Russian Bailiffs Service and the Enforcement of Civil Judgments. *Post-Soviet Affairs* 18, 148-181.
- Kenworthy, Lane, Macaulay, Stewart, Rogers, Joel, 1996. ‘The More Things Change’...: Business Litigation and Governance in the American Automobile Industry. *Law and Social Inquiry* 21, 631-678.
- Leitzel, Jim, Alexeev, Michael, Gaddy, Clifford, 1995. Mafiosi and Matrioshki: Organized Crime and Russian Reform. *The Brookings Review* 13 (Winter), 26-29.
- McMillan, John, Woodruff, Christopher, 1999a. Dispute Prevention without Courts in Vietnam. *Journal of Law, Economics and Organization* 15, 637-658.
- \_\_\_\_\_, 1999b. Interfirm Relationships and Informal Credit in Vietnam. *Quarterly Journal of Economics* 98, 1285-1320.
- Macaulay, Stewart, 1963. Non-Contractual Relations in Business: A Preliminary Study. *American Sociological Review* 28, 55-67.
- \_\_\_\_\_, 1977. Elegant Models, Empirical Pictures and the Complexities of Contract. *Law and Society Review* 11, 507-528.

- Milgrom, Paul, North, Douglass, Weingast, Barry, 1990. The Role of Institutions in the Revival of Trade: The Medieval Law Merchant, Private Judges, and the Champagne Fairs. *Economics and Politics* 2, 1-23.
- Murrell, Peter, 2001. Demand and Supply in Romanian Commercial Courts: Generating Information for Institutional Reform. Mimeo.
- Murrell, Peter, 2003a. Firms Facing New Institutions: Transactional Governance in Romania. *Journal of Comparative Economics* 31, 695-714.
- Murrell, Peter, 2003b. The Relative Levels and the Character of Institutional Development in Transition Economies. In: Campos, Nauro and Jan Fidrmuc (Eds.), *Political Economy of Transition and Development: Institutions, Politics and Policies*. Kluwer Academic Publishers, Boston/Dordrecht/London, pp. 41-68.
- North, Douglass C., 1990. *Institutions, Institutional Change and Economic Performance*. Cambridge University Press, New York, NY.
- Olson, Mancur, 1982. *The Rise and Decline of Nations*, Yale University Press, New Haven, CT.
- Priest, George L., Klein, Benjamin, 1984. The Selection of Disputes for Litigation. *Journal of Legal Studies* 13, 1-55.
- Pyle, William, 2005. Contractual Disputes and the Channels for Inter-firm Communication. *Journal of Law, Economics and Organization*, 21.
- Rajan, Raghuram, Zingales, Luigi, 1995. What Do We Know about Capital Structure? Some Evidence from International Data. *Journal of Finance* 50, 1421-1460.

- Ramasasty, Anita, 2002. What Local Lawyers Think: A Retrospective on the EBRD's Legal Indicator Surveys. *Law in Transition* (Autumn), 14-30.
- Rodrik, Dani, 2000. How Far Will International Economic Integration Go? *Journal of Economic Perspectives* 14, 177-186.
- Schaffer, Mark, 1998. Do Firms in Transition Economies Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence. *Journal of Comparative Economics* 26, 80-103.
- Schönenfelder, Bruno, 2003. Debt Collection and Bankruptcies in Slovakia: A Study of Institutional Development. *Post-Communist Economies* 15, 155-180.
- Varese, Federico, 2001. *The Russian Mafia: Private Protection in a New Market Economy*. Oxford University Press, New York, NY.
- Williamson, Oliver, 1996. *The Mechanisms of Governance*, Oxford University Press, New York, NY.
- Woodruff, Christopher, 1998. Contract Enforcement and Trade Liberalization in Mexico's Footwear Industry. *World Development* 26, 979-991.
- World Bank, 2004. *Doing Business in 2004: Understanding Regulation*. Washington, D.C.
- \_\_\_\_\_, 2002. *World Development Report: Building Institutions for Markets*. Washington D.C.

---

<sup>1</sup> The author would like to thank Timothy Frye, Paer Gustafsson, Christa Hainz, Peter Matthews, Peter Murrell, Jeff Carpenter, Jessica Holmes and seminar participants at Middlebury College for their helpful comments.

<sup>2</sup> Better institutions encourage firms to engage in transactions that they might have otherwise avoided and though they may lower the probability that any given transaction will lead to a dispute, they may increase the number of transactions and, thereby, the number of disputes.

<sup>3</sup> The cited source provides a comprehensive description of the survey project from which the lead investigators published several noteworthy articles (Johnson, Kaufmann, McMillan and Woodruff, 2000; Johnson *et al.*, 2002a; and Johnson *et al.*, 2002b). Surveys in the project were also administered in Russia and Ukraine, but the coverage of payment dispute specifics was limited; indeed, several of the relevant questions appear not even to have been asked.

<sup>4</sup> Hendley (2004a), moreover, contends that their relative simplicity makes them more transparent and thus less prone to corrupt influences if resolved in government courts.

<sup>5</sup> Johnson *et al.* (2002a) base their conclusions on data from the same EBRD sponsored survey used for this article. In addition to Poland, Slovakia and Romania, they also have data for their variables of interest from Russia and Ukraine.

<sup>6</sup> The Business Environment and Enterprise Performance Survey (BEEPS), sponsored by the World Bank and the European Bank for Reconstruction and Development, focused on a wide range of interaction between firms and the state. It was administered to over 4000 firms in 22 transition countries, including 100-plus firms in each of the country's highlighted in the analysis here.

---

<sup>7</sup> Restricting the sample to those firms with between ten and 200 employees (*i.e.*, sizes comparable to those enterprises whose behavior is analyzed later in the paper) does not appreciably change the percentages for any of these responses.

<sup>8</sup> This contrast is also depicted in a more macro-oriented study of the relationship between legality and the extent of financial market development during the transition (Gelfer, Raiser and Pistor, 2000).

<sup>9</sup> Quickness does not measure quality in the direct manner in which the first four measures cited do; quickness, as Murrell (2001) shows for Romania, diminishes as a court's caseload grows, which itself may respond positively to perceived quality and effectiveness.

<sup>10</sup> More recent data suggest Poland no longer possesses unusually high court costs within the context of the CEE region. Lawyers in a number of countries were asked about the costs of using the court system to collect an overdue payment equal to half of GNI per capita. Court costs, including attorney fees and payments to professionals like accountants and bailiffs, in Poland, Slovakia and Romania, were estimated at 11.2%, 13.3% and 13.1%, respectively, of GNI (Djankov *et al.*, 2003; World Bank, 2004).

<sup>11</sup> Hendley *et al.* (2000) argue that business associations play only a peripheral role in enforcing contracts in Russia. Murrell (2003b) explains what he sees as an anomalous result from Russia in the early 1990s (Greif and Kandel, 1995; Recanatini and Ryterman, 2001) as a consequence of its under-developed public institutions.

<sup>12</sup> The five countries include Poland, Slovakia, Romania, Ukraine and Russia. The results, however, are not contingent upon the inclusion of the firms from the former Soviet Union.

---

<sup>13</sup> In Poland, the respondents were firms in Katowice; in Romania, Brasov; and in Slovakia, roughly half of the firms were from Kosice and Bratislava with the rest coming from one of seven other cities. The firms represented the following branches within manufacturing: metal, wood, food and chemical products, clothes, construction materials, paper and packaging, handicrafts and electrical machinery.

<sup>14</sup> The difference in the response rates (between the BEEPS data in Table 1 and the Table 2 data) as to courts' capability of enforcing contracts may well reflect different thresholds for a positive response. In the BEEPS survey, managers were recorded as having characterized the courts as "able to enforce" contracts if they reported at least "frequently" associating them with that characterization. If the threshold was instead "sometimes," the sets of numbers are similar.

<sup>15</sup> The survey here was conducted in Brasov, which is located in the southern portion of Transylvania.

<sup>16</sup> The response "local government" is merged with "court" given the small numbers – 0.8% of all firms – associated with the former.

<sup>17</sup> Hendley (2004a) concludes from an investigation of 100 court cases that disputes over large amounts are relatively less likely to come before the courts since the larger firms are less interested in opening up their affairs to state scrutiny.

<sup>18</sup> Of course, it is possible that a seller does not inform the buyer of his grievance in which case the dispute never goes beyond the first stage. Felstiner *et al.* (1980-81) refer to the occurrence of the violation as the first – or the "naming" – stage. A subsequent appeal to the buyer is referred to as the "blaming" stage. We think it unlikely that the respondents to the

---

survey – answering questions about “your most recent payment dispute” with a customer – would have thought of incidents that progressed no further than this first stage. Felstiner *et al.* (1980-81) include any appeals to private mediators as a part of this blaming stage.

<sup>19</sup> Murrell (2001) notes that non-payment claims in Romania can be filed in the jurisdiction where the defendant is located, where the obligation was created or where the payment was due to be made.

<sup>20</sup> The author’s conversations with personnel at the Center for International Private Enterprise (an independent, non-profit affiliate of the U.S. Chamber of Commerce, which assists nascent business organizations in emerging markets throughout the world) confirmed that many of the associations in Poland, Slovakia and Romania provide their constituents with a regular flow of information on the evolving legal system. Moreover, in a survey of 200 business associations conducted by the author in Russia in the summer of 2004, 85% reported offering their clients information related to changes in laws and regulations.

<sup>21</sup> The authors find that 81% of small firms in the BEEPS survey (fewer than 50 full-time employees), 57% of medium-size firms (50 – 249) and 38% of large firms report that none of their payment disputes were resolved in court.

<sup>22</sup> Broadman *et al.* (2004) find that state firms, across the region, are more informed about laws and regulations and that they find courts’ interpretations of them more consistent and predictable. They also report that state-owned firms have a higher proportion of payment disputes resolved in court. We should note, however, that these are bilateral relationships.

<sup>23</sup> Hendley (2004a) finds that 14% of firms filing suit in Russian non-payment cases filed the suit in order to “send a message to other customers that not paying is unacceptable?” She

---

argued the number was not higher because case decisions are not published and, therefore, are unlikely to become known to third parties.

<sup>24</sup> The dependent variable takes on the value of 0 if the dispute was resolved either without any outside assistance or with the help of a private agency, with the latter constituting less than 5% of all reported payment disputes.

<sup>25</sup> We exclude from the analysis the five firms that used both the court system and a private agency.

<sup>26</sup> In this and all subsequent regressions, controls are included for the percentage of the firm's total sales made to customers of different ownership types (*e.g.*, state enterprise, privatized firms, greenfields, *etc.*) and locations *vis à vis* the respondent (*e.g.*, in the same city, elsewhere in the country, abroad).

<sup>27</sup> It might be presumed that willingness to join a business organization is a proxy for willingness to operate in the formal sector of the economy. The positive association between business association membership and using the courts might thus be explained by this third variable. However, when running the models presented in Table 5A with a variable that has been used by others to capture informality – hidden sales as a percentage of actual sales for “firms in your industry” (Johnson, Kaufmann, McMillan and Woodruff, 2000) – the magnitude and statistical significance of our variables of interest do not change in the least.

<sup>28</sup> Moreover, we should note that disputes that occurred earlier are more likely to have ended up in court. Since the language of the survey makes clear that the questions refer to disputes that have ended or been resolved, this finding suggests that contrary to conventional wisdom, recourse to courts for a standard business dispute is becoming less common with

---

time. This perhaps can be understood as a result of a greater understanding of the costs of litigation or more experience with non-litigious mechanisms for dispute resolution.

<sup>29</sup> The role of association membership is not sensitive to the geographic distance between the firms in the manner observed in the litigation regressions – *i.e.*, there is no statistically significant effect of the interaction between association membership and the customer being located “elsewhere in the country.”

<sup>30</sup> In another variant of the association-as-informational-node story, there is a good deal of evidence that business organizations provide members with access to information about the reliability of business partners (Macaulay, 1963; Doner and Schneider, 2000; Pyle, 2005; Woodruff, 1998). It is thus possible that association members are more likely to be involved in disputes with customers that experience only temporary as opposed to permanent payment difficulties. In other words, business association membership may be correlated with the dispute’s severity, a variable that we do not observe.

<sup>31</sup> The inclusion of this control makes more sense within the context of a model restricted to intra-country disputes. We have no reason to believe that business associations from one country can exercise influence over public institutions in another.

<sup>32</sup> When splitting the sample between firms that had litigated and those that had not and re-running the model on both, we find the effect of association membership remains positive and statistically significant, the coefficient increasing in magnitude, in both.

<sup>33</sup> To test whether the coefficient on taking the dispute to court reflects selection effects, we ran a bivariate probit model with the outcome in the second regression being full recovery of the payment. In the treatment regression, we add an additional selection variable: the

---

respondent's belief that the court can enforce contracts. We observe that the value of rho, the correlation between the error terms of the two equations, is not statistically different from zero, thus suggesting no selection bias. The coefficient on the "court did assist" variable in the outcome regression, however, is positive and statistically significant.

<sup>34</sup> A state-owned firm may be able to bring more pressure to bear on a delinquent customer than another firm that is otherwise similar. We do not, however, observe a similar state-ownership bias with respect to the customer. Indebted state firms are no less likely than non-state firms to pay off the amount in dispute. Perhaps the effect of increased bargaining power is negated, in part, by softer budget constraints.

<sup>35</sup> Firms that have established relationships with fewer new customers in the past year are more likely to have satisfactorily resolved their dispute. It is possible that, *ceteris paribus*, a firm with less turnover in its client base is able to devote more resources to screening per each new customer. This may mean that they are more likely than those that screen less to be dealing with more reliable customers whose payment difficulties are relatively more likely to be temporary than permanent. That is, again, a variable may be proxying for the dispute's severity.

<sup>36</sup> The termination of the relationship may have been due to circumstances unrelated to the dispute, but the data, however, do not allow us to distinguish these cases. We only know whether or not the firm in question remained a customer of the respondent at the time of the survey.

<sup>37</sup> We also see some evidence that firms that have a long and enduring relationship are more likely to have that relationship derailed in the aftermath of a payment dispute. Although the

---

statistical significance of this finding does not hold up in the model that includes just intra-country disputes (see column 2), this is a surprising result, since it has been suggested that longer relationships allow partners to build up a better capacity to cooperate and work through difficulties (Macaulay, 1963; Macaulay, 1977). Moreover, one might suspect that in a long relationship, the impact of one piece of information – a single unpaid bill – would be less damaging to the supplier's evaluation of the customer than in a relationship in which the parties share less of a history together.