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Who Tolls the Bells for Firms? Tales from Transition Economies

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Bankruptcy law is regarded as an important mechanism for protecting creditor rights. Much of the current debate about bankruptcy law focuses exclusively on private creditors, ignoring the role of tax authorities as creditor in insolvent firms. Based on data from several transition economies, this essay documents the important, if not dominant, role tax authorities play as initiator of bankruptcy in these countries. While improved tax enforcement is crucial for tackling the problem of tax arrears and hardening the “soft budget-constraint” in former socialist countries, this essay suggests that the presence of the tax authorities as creditor may also affect the cost of debt financing and may have contributed to the difficulties firms in these countries continue to have in obtaining longer term debt finance. This is the case in particular when the tax authorities shift from a low to a high enforcement regime in an environment where firms had already accumulated substantial tax arrears in the past, making the tax authorities senior creditors in bankruptcy. This essay follows Desai et al. in asking for more attention to be paid to the tax authorities as stakeholders in firms. Contrary to Desai et al., however, the paper suggests that the role of the tax authorities cannot be limited to that of a minority share-
I. INTRODUCTION

A central question in the theory of the firm is why firms exist at all. The question of why firms "die" has been much less contentious. The expectation is that once a firm's liquidation value exceeds its value as a going concern, it will exit the market and its assets will be redeployed to more efficient use. Firms do not necessarily exit voluntarily, mostly because their owners or managers have a vested interest in keeping them afloat, if only to protect their jobs. However, creditors may push firms into bankruptcy. They can initiate bankruptcy directly, or they can pursue a firm hard enough so that it seeks bankruptcy protection "voluntarily."

This scenario rests on the assumption that markets work effectively in sorting performing from nonperforming companies. This essay challenges the notion that the exit decision is necessarily market-driven. It investigates who controls the exit decision for firms in transition economies, i.e. markets and institutions that have not yet

completely emerged from the institutional infrastructures of the collapsed socialist regimes. Legal institutions—including formal legal protections of creditor rights, collateral regimes, and bankruptcy procedures—were established and designed to further the development of such markets. Given the legacy of socialism, it is perhaps not surprising that the actual use of these new legal institutions has often deviated from the purpose for which they had been created. This has been particularly obvious in the context of credit markets. Creditors—including financial and trade creditors—have been slow to use bankruptcy as a means for recovering their debt. Instead, as this essay documents, the state has played a crucial role in the bankruptcy process. In its role as tax creditor, the state initiates bankruptcy and imposes financial discipline on firms; but occasionally it also reestablishes state control over economic assets.

The reemergence of state control over economic assets in former socialist regimes is a somewhat ironic outcome. The major goal of privatization and the broader economic and legal reforms in these countries was to "get the state out," and to "depoliticize" economic decision-making. The chosen means to achieve this was the privatization of state-owned enterprises, thereby transferring key decision-making powers to private agents. It has been widely assumed that once ownership rights have been reallocated, economic decision-making can be safely de-politicized. If markets still fail to develop, the causes must lie in weak laws or weak legal institutions. Not surprisingly, the second wave of reforms in transition economies and other emerging markets has focused on strengthening legal institutions to ensure market development.

Removing state agents from a position in which they can control a company as owners, however, does not necessarily imply that state control has subsided, as evidenced by the data presented in this essay on the state as major creditor in the economy. Moreover, at least temporarily, privatization left substantial stakes in most firms

2. See Maxim Boycko, Andrei Shleifer & Robert Vishny, Privatizing Russia 11–13 (1995) (arguing that the de-politicization of assets was the single most critical purpose of the mass privatization program the authors designed for Russia).

3. See, e.g., Cheryl W. Gray & Kathryn Hendley, Developing Commercial Law in Transition Economies: Examples from Hungary and Russia, in The Rule of Law and Economic Reform in Russia 139–64 (Jeffrey D. Sachs & Katharina Pistor eds., 1997) (arguing that a major function of legal technical assistance in the former socialist countries was to install good laws and subsequently to improve the enforcement of such laws).

under state-ownership. Available evidence on how governments and their agents used these remaining minority stakes suggests that in most cases the state has been a passive owner. Still, the sheer number of partially state-owned firms in the early transition period suggested that "getting the state out" was akin to trying to kill the many-headed Hydra. In most firms today, the Hydra metaphor seems even more appropriate when examining the role of the state as creditor. In many transition economies, the state emerged as the largest creditor in the economy. These days, the chunk of state credits is not channeled through state-owned banks, which have since been privatized, closed down, or marginalized by the influx of foreign and private banks. Instead, the main source of state financing for firms has taken the form of tax arrears.

The state's role in financing the private sector by way of unenforced tax claims raises the specter of the "soft budget-constraint," the defining feature of socialist economic management, continuing well beyond the demise of the socialist system. Examining available evidence in the 1990s, economist Mark Schaffer concludes that in many transition economies tax arrears were sub-

5. Interviews with state agents in charge of managing these state assets suggest that they were too under-staffed to attend board meetings regularly and had no clear policy guidance as to how to use state assets. See Katharina Pistor & Joel Turkewitz, Coping with Hydra—State Ownership after Privatization, in CORPORATE GOVERNANCE IN CENTRAL EUROPE AND RUSSIA 192,194–209 (Roman Frydman, Cheryl W. Gray & Andrzej Rapaczynski eds., 1996) (documenting the extent of remaining state ownership in countries that sought to privatize rapidly and providing evidence on the management of state ownership from interviews).

6. See id. at 209.


9. János Kornai, a Hungarian economist who taught for many years at Harvard University, first coined the term "soft budget constraint" as referring to government bailouts of firms, which he attributed to the desire of paternalistic governments to avoid social and political costs of firm closure. See, e.g., JÁNOS KORNAI, THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM 489 (1992). Today the term is more widely applied to refer to dynamic commitment problems in the face of irreversible investments. See Mathias Dewatripont & Gérard Roland, Soft Budget Constraints, Transition, and Financial Systems, 156 J. INSTITUTIONAL & THEORETICAL ECON. 245 (2000); Schaffer, supra note 8.

stantial and that they, rather than direct subsidies, were the greatest source of soft budget-constraint.  

Similarly, economist Ariane Lambert-Mogiliansky et al. have shown that regions of Russia with governors who were hostile to economic reforms have often shielded companies from liquidation by making extensive use of reorganization procedures, which prolonged their survival.  

Even more problematic is how the state wields its rights as creditor— to pull the trigger and force a firm to exit—which is the most powerful control right of any stakeholder.  

Certainly, exercising this power is a prerequisite for hardening the soft budget-constraint in transition economies. Yet, this very power could also be used to reestablish state control over key aspects of economic decision-making, and indeed over crucial economic assets. The Yukos case in Russia (further discussed below) suggests that such a scenario is plausible.

This essay presents detailed data from two transition economies, Hungary and Russia, on the state’s role as initiator of firms’ bankruptcy. Available data on the initiator of bankruptcy proceedings over a period of five years show that the state continues to be a powerful stakeholder in firms in these countries. The study analyzes how the state has used its powers, in particular whether it acted primarily to help establish financial discipline, enforce its own budgetary claims, or use bankruptcy to regain economic control in the aftermath of privatization. It then suggests that the function of bankruptcy proceedings differs remarkably across the two countries. In Hungary, state intervention into the bankruptcy process is primarily a financial-discipline enforcement-device with the state being slightly more invested in smaller rather than larger companies. In Russia, by contrast, bankruptcy has become a control device in the hands of a powerful tax service. In fact, the tax authorities now control both exit and entry, because they have also been put in charge of maintaining the official enterprise register. On occasion, bankruptcy has even been used to re-nationalize assets.

One obvious (and familiar) implication of these findings is that the functions of legal institutions, such as bankruptcy, differ widely from country to country and are highly context-specific.
Therefore, simple quantitative studies that attempt to relate the number of bankruptcies in a given country to the level of creditor rights protection (such as a recent study conducted by scholars at the World Bank) seem somewhat misguided, as they ignore the identity of the agents who trigger bankruptcy, or the nature of the companies that are forced into bankruptcy. The same is true for studies that link legal protection to even more remote economic outcomes, such as credit-market development, which is typically measured by the volume of claims financial institutions have outstanding against the private sector. These studies fail to explain the mechanisms that relate the law on the books to financial markets as the observed empirical outcome; neither do they conclusively show that shareholders or creditors actually exercise the rights given to them by law, nor that these rights are enforceable within a given legal system.

Yet, the major point this essay seeks to make is a different one. As has been noted above, the question of who determines the ultimate fate of a firm is hardly addressed in the literature on the theory of the firm or the theoretical bankruptcy literature. While there is substantial discussion about allocating the bankruptcy-initiation power to either the debtor or the creditor, the discussion for the most part assumes a simple contractual relation between a private debtor and a private creditor, each maximizing its economic interests.


16. See Ross Levine, The Legal Environment, Banks, and Long-Run Economic Growth, 30 J. MONEY, CREDIT & BANKING 596 (1998). The basic analytical framework for this research was developed in Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, Law and Finance, 106 J. POL. ECON. 1113 (1998) (arguing that legal institutions greatly influence the development of credit and stock markets). For a more detailed account of law as a determinant of credit markets, see also Pistor et al., using a similar framework to investigate the role of law as a determinant of credit market development in transition economies in the 1990s. Katharina Pistor, Martin Raiser & Stanislaw Gelfer, Law and Finance in Transition Economies, 8 ECON. TRANSITION 325 (2000). Their results suggest that specific legal intervention is less relevant for market development than a country’s overall performance on rule-of-law indicators.

These discussions have missed the relationship between debtors and tax authorities, who can be cast as creditors to those debtors that have large tax arrears.

This essay focuses on tax creditors and their role in determining the timing and outcome of bankruptcy. It documents the dominant role the state plays in determining the fate of firms in transition economies, including those that have implemented extensive privatization programs. In these countries it is by way of enforcing past tax liabilities that the state now determines the future of firms. This essay thus joins a growing debate about the role of the tax authorities in the corporate governance of firms. Desai, Dyck, and Zingales first emphasized this role in a recent paper, and they describe the tax authorities as a “minority shareholder.” This characterization stems from the fact that the tax authorities participate in future profits of the firm. According to Desai et al., levying a profit tax, and making a credible commitment to enforce such a tax, creates a powerful governance device not only for the state, but also indirectly for minority shareholders. The effect of a corporate tax on minority shareholders, according to this analysis, depends on the quality of the governance structure in place. When governance structures are weak, i.e. when blockholders control the firm unchallenged by minority shareholders, an increase in the tax rate will increase a blockholder’s return from stealing. The more a blockholder steals, the lower the firm’s profits and thus the lower the effective tax rate the firm will have to pay to the tax authorities. However, Desai et al. also suggest that strengthening tax enforcement can increase the return to minority investors and thereby enhance overall corporate governance. They argue that effective tax enforcement forces the firm to disclose its assets not only to the tax authorities, but also to its shareholders. The authors use Russia as a case study to demonstrate the relation between improved tax enforcement in the Putin era and increases in stock prices of publicly traded firms.

This essay explores a different aspect of the relationship between tax authorities and private firms. It suggests that depicting the tax authorities as an equity holder misses part of the story. Although the tax authorities do not receive a fixed return on their investment, as creditors typically do, they have a claim against the future profits of the firm, as equity holders typically do. However, once a firm defaults on its tax obligation, the tax authorities’ claims automatically

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19. Id. at 592.
20. Id.
convert into a debt claim. Most importantly, like creditors, they wield the power to trigger bankruptcy proceedings against such a firm. It therefore seems to be more appropriate to characterize the tax authorities as a holder of “convertible equity.”

Still, tax authorities differ from ordinary creditors in important ways. Most importantly, their objectives are not only to secure future repayments of debt owed by a particular firm, but also to enforce tax compliance more generally. As a result, they may be less inclined to refinance or defer repayment. Moreover, tax authorities are designed by law to be more powerful than unsecured creditors; failure to pay taxes typically allows the tax authorities to unilaterally create a lien over the tax debtor’s assets. Furthermore, most bankruptcy codes allow the tax authority to recover prior to unsecured creditors.

The role of the tax authorities as a claimant in a firm’s bankruptcy has been neglected by much of the theoretical bankruptcy literature. This essay hopes to stimulate further inquiry by analyzing the special role of tax authorities as creditors in the context of transition economies. Like a magnifying glass, these countries reveal tensions in governance structures that tend to go unnoticed in developed economies.

This essay is organized as follows. Section II discusses the “initiation problem,” that is, the optimal allocation of the power to trigger bankruptcy proceedings. Section III presents summary data on bankruptcy initiation in Hungary and Russia, which suggest the extensive role the state plays as tax creditors in firms. Section IV examines available data for Hungary and Russia in greater detail to determine the purpose of state-initiated bankruptcies in these two countries. Section V reflects on the role of bankruptcy taking into account the tax authorities as a crucial stakeholder of firms in transition economies. Section VI summarizes the main findings and makes suggestions for future research.

II. WHO SHOULD TOLL THE BELLS FOR FIRMS

Firms are creatures of human action. They do not emerge; they are established. Nor do they die a natural death; they are shut down. This raises the question as to who should decide when to close a firm. Traditionally this decision lies in the hands of two groups: creditors and debtor-owners. This section explores the allocation of the power to trigger bankruptcy between these two groups, and what the optimal allocation of this authority would be in econo-
mies at different stages of development.

For solvent firms, the answer is simple: the firm's owner, as
the holder of its residual rights of control, should exercise the power
to shut down the firm. For insolvent firms, the answer is more com-
plicated. Insolvency implies that the combined claims of all creditors
exceed the firm's assets, i.e., after their claims are enforced, there are
no assets left over which the owners could exercise their residual
rights of control. This suggests that creditors should have the power
to initiate a firm's exit. Creditors may, however, suffer from inform-
ation asymmetries and face difficulties verifying when a firm is
temporarily illiquid, as opposed to permanently insolvent. Creditors
also face serious collective action problems. Each creditor is better
off when enforcing her claim individually, while all creditors share a
collective benefit from an orderly procedure, even though through
this procedure some might only be satisfied pro rata or leave empty-
handed.\footnote{See Baird, supra note 17, at 226.}

It has therefore been suggested that a system that favors the
debtor's initiation of bankruptcy is superior to a regime dominated by
creditors.\footnote{Id. at 229.} The reason is that the debtor knows best when the line
between temporary illiquidity and insolvency has been crossed.
Since the debtor (or agents acting on its behalf) has strong incentives
to delay or avoid bankruptcy, a regime where debtors are supposed to
initiate bankruptcy requires an appropriate incentive structure for the
debtor to take action. Giving the debtor the option to initiate a reor-
ganization procedure and thereby avoid the immediate liquidation of
the firm appears to be such a device. The major benefit of a "soft"
reorganization regime thus appears to be its ability to resolve the ini-
tiation problem,\footnote{See Povel, supra note 17, at 673.} even though this does not come without costs,
since many firms that enter reorganization should probably be liqui-
dated immediately.\footnote{Douglas G. Baird & Edward R. Morrison, Serial Entrepreneurs and Small Business
Bankruptcies, 105 COLUM. L. REV. 2310, 2340 (2005).} By contrast, a pure liquidation regime, i.e. one
that makes reorganization contingent on creditor consent, leaves the
initiation decision ultimately in the hands of creditors.

Recent work has sought to relate the allocation of the bank-
ruptcy initiation power to the structure of an economy, rather than de-
termining the optimal allocation of these powers in the abstract. Economists Berkovitch and Israel characterize economic systems
based on their information structure.\footnote{See Berkovitch & Israel, supra note 17, at 353.}
which information costs are low and managers and creditors rely on similar information to determine the future viability of the firm, from systems where managers enjoy a significant information advantage over creditors because of the high costs and low quality of information. In addition, they analyze the nature of financing relations as either arms-length or involving long-term credit relations, i.e. with banks. Based on these characteristics they conclude that in developed economies with a bank-based system and well-developed information-acquisition technologies—resulting in reduced information asymmetries—creditors should have the final say over the future of the firm. By contrast, developed economies with arms-length financing and equally well-developed information-acquisition technologies, should have both creditor and debtor chapters.26

The major difference between these two types of developed economies, according to Berkovitch and Israel, is that in bank-centered systems, information is hard, meaning that the manager can predict the outcome of creditors’ investigation into the viability of the firm and thus respond strategically by either initiating bankruptcy himself or continuing the firm.27 In market-based systems, by contrast, information is more dispersed and “soft,” making it more difficult for the manager to act strategically. At the same time, the creditor may over-enforce bankruptcy. Debtor-initiated bankruptcy thus works as an important defense against over-aggressive creditors in a market-based financial system. Finally, countries with poor information-acquisition technologies and concentrated financing should also have both creditor and debtor chapters. The reasoning here is that in a low-quality-information environment, managers have a strategic advantage over creditors because they have better information upon which to base their assessment of the viability of the firm. Creditors can access this information only through management, not through their own independent investigation. A system that exploits managers’ superior information where it exists, i.e. one that includes a debtor chapter, is thus superior to one that lacks it. However, since managers may abuse their strategic advantage, Berkovitch and Israel argue that creditors should also have the option to initiate and control bankruptcy.28

It follows, therefore, that transition economies should have both a debtor and a creditor chapter. Information quality has been notoriously low in the former socialist countries, characterized by the absence of market prices, reliable firm-specific information, as well

26. Id.
27. Id. at 364.
28. Id.
as intermediaries capable of collecting and verifying relevant information.29 In such an environment firm insiders are bound to have superior information.30 Nevertheless, in most transition economies bankruptcy-initiation powers are biased heavily in favor of creditors.31 The rationale seems to have been to impose financial discipline on firms after they had operated for too long under a "soft budget-constraint."

Based on the analysis provided by Berkovitch and Israel, however, a more appropriate strategy may have been to improve debtors' incentives to initiate bankruptcy, rather than to tilt the balance of power too much in favor of often-uninformed creditors.32 The same could be said for most other countries' bankruptcy regimes. While most countries allow both creditors and debtors to initiate bankruptcy proceedings, most favor creditor-initiated bankruptcy.33 The bias in favor of creditor-initiated bankruptcies has been maintained despite the fact that in recent years many countries have either introduced or strengthened reorganization procedures. However, in these countries creditors, not debtors, control entry to reorganization. While in the US a debtor can file for Chapter 11 reorganization, in most other countries, liquidation is the default procedure and creditor consent is required for switching from liquidation into reorganization.34

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31. See Katharina Pistor, *Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies*, 1 EUR. BUS. ORG. L. REV. 59 (2000) (coding creditor rights protection in bankruptcy codes and civil codes (for collaterals) in 24 transition economies and finding a strong bias in favor of creditor rights consistent with the legacy of these countries as mostly German civil law countries).

32. See supra note 9, for the literature on soft budget constraints.

33. See supra note 17.


35. See Baird, supra note 17, at 227-28 (discussing the ability of a manager to file for
III. **WHO TOLLS THE BELLS FOR FIRMS? RECENT DATA FROM TRANSITION ECONOMIES**

This section presents recent data about which agents have been the most active bankruptcy initiators in Hungary and Russia. Table 1 below presents summary evidence. The scope of the study was limited to these two countries because this kind of data is notoriously difficult to collect; only a few countries collect these data at the national level or make them publicly available. The table presents the average number of bankruptcies filed in these two countries over a period of four to five years (depending upon data availability). It also shows the share of bankruptcy proceedings in court that have been initiated by debtors or creditors, and differentiates between state creditors and private creditors.

Table 1: Initiators of Bankruptcy Proceedings in Court in Hungary and Russia (1999–2003)*

<table>
<thead>
<tr>
<th>All data = average per year</th>
<th>Hungary</th>
<th>Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cases initiated</td>
<td>13,598</td>
<td>39,953</td>
</tr>
<tr>
<td>By debtor</td>
<td>1512</td>
<td>4306</td>
</tr>
<tr>
<td>By creditor</td>
<td>12,713</td>
<td>35,647</td>
</tr>
<tr>
<td>State creditors</td>
<td>4911</td>
<td>34,199</td>
</tr>
<tr>
<td>Private creditors</td>
<td>7801</td>
<td>1448</td>
</tr>
</tbody>
</table>


* Excluding accelerated procedures against “absentee” debtors.

As these data illustrate, the number of bankruptcy filings varies substantially between the two countries. As an initial matter, differences in bankruptcy filings across countries can be difficult to account for, because the propensity to file depends on economic conditions and the incentive structure for creditors or debtors to initiate proceedings. Notwithstanding these limitations, one possible benchmark for comparison are other European countries for which filing data are available. Interestingly, the bankruptcy rates in Hungary are roughly comparable with those of other Western European

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Chapter 11 reorganization). For a broader comparative perspective, see Claessens & Klapper, *supra* note 34, at 7–8.

36. In fact, neither Hungarian nor Russian officially published sources break down the data in the way I present them here. However, I was able to obtain these data directly from the Russian Supreme Arbitrazh Court and Hungarian Ministry of Justice.
A recent study of insolvencies in Europe found that Germany had about 135 insolvencies per 10,000 companies (equaling 1 percent), France 160 (1.5 percent), and Italy 39 (.03 percent). The equivalent number for Hungary was 90 (.09 percent). Similar data for Russia were not available. According to data compiled by the Federal Tax Services, in 2003 there were over 2 million companies (of which 170,000 are joint stock companies) registered in Russia. According to their data, over 30,000 companies (or 1.5 percent) were in the state of liquidation in 2003. It should, however, be noted that in 2003 overall bankruptcy filings had declined substantially.

More interesting for the purpose of this essay, however, is the identity of the bankruptcy initiator. It is particularly striking that creditor filings make up such a substantial number of bankruptcies proceedings, as well as what appears to be a high share of bankruptcy filings by the state.

The strong bias in favor of creditor-initiated bankruptcy-proceedings appears to be a feature of the formal law. In Hungary, while debtors may initiate a reorganization procedure, they have to obtain creditor consent for a moratorium within 30 days of filing. Furthermore, at least half of all creditors must be present to take binding decisions. If the debtor fails to obtain creditor consent for a moratorium, the court terminates reorganization, opening the way for creditors to bring a liquidation action. Moreover, even if creditor consent has been obtained, management autonomy is significantly curtailed in bankruptcy, as the court will appoint a bankruptcy trustee who has the power to approve any financial commitment of the company beyond an amount fixed by the creditors.

In Russia, the law facilitates creditor filing even more. The decision of whether a firm will go into reorganization, be subjected to administrative management by a court-appointed receiver, or enter liquidation proceedings, is made only after bankruptcy has been initiated. The debtor there-
fore cannot stack the cards in his favor by bringing a reorganization proceeding. As a result, debtors have few incentives to initiate bankruptcy in the first place. Creditor dominance of the bankruptcy-initiation decision is not limited to transition economies, but it is the norm even in Western market economies. The lone exception is the United States, where "voluntary" or debtor filings make up more than 90 percent of all bankruptcy filings.\(^4^5\)

What is more remarkable is the share of bankruptcy proceedings that the state has initiated. Between 1999 and 2003, state agents initiated on average 85.6 percent of all bankruptcy cases in Russia. The majority of these cases were initiated by the tax authorities (see Table 4, infra). Even in Hungary, state-initiated bankruptcies accounted for, on average, 36 percent of filings between 1999 and 2003. In both countries the tax authorities are the most important state agents involved in bankruptcy. The legacy of tax arrears in transition economies explains the strong presence of tax authorities. During the first part of the 1990s, tax authorities lacked the capacity to effectively enforce taxes. Moreover, taxes were levied not only on profits, but on excess wages, effectively imposing an income tax on firms.\(^4^6\) The effect of this legacy is that the state has become one of the largest, if not the largest, creditors in the economy with the discretion to exercise the full range of powers that come with this position.

The strong presence of tax authorities as creditors may be motivated by several state objectives: pedagogical, creditor, or predatory. First, the state may have stepped into the void and triggered bankruptcy in an attempt to familiarize private agents with the procedure, hoping that this would eventually give rise to a purely market-driven process (a pedagogical function). Second, the state may be enforcing its own claims to increase budget revenue and improve financial discipline in the long term (a creditor function). Third, the state may be using bankruptcy as a means to regain control over decision-making, and possibly over key assets in the economy (a predatory function).


There is some evidence in support of each of these propositions. With respect to the state's pedagogical function, it is worth noting that the introduction of bankruptcy codes in transition economies did not trigger a wave of bankruptcy filings, as would have been expected by those believing in the power of the market to produce efficient outcomes once institutional obstacles have been overcome. During that time, many firms experienced serious liquidity problems and a substantial share of them were technically insolvent. Hungary tried to resolve this problem by introducing a so-called automatic trigger in 1992.\(^{47}\) The law, entered into force in January 1992, required each debtor unable to pay its obligations for 90 days to file for reorganization. The total number of debtor-initiated reorganizations almost quadrupled from 724 cases filed in the first quarter of that year, to 2259 cases filed in the second quarter. The number of bankruptcy filings decreased only after the automatic trigger was removed in 1993. Since then, reorganization cases have accounted only a tiny fraction of all insolvency cases filed in Hungarian courts.\(^{48}\)

With hindsight, the introduction of an automatic trigger appears to have been a flawed attempt to impose market-discipline on firms. Comparative studies quickly revealed that in developed-market economies, deferring payment for 90 days or more is common practice and does not give rise to immediate enforcement action by creditors.\(^{49}\) In the context of transition economies, such drastic action seemed particularly inappropriate, as most firms were experiencing serious financial stress resulting from the economic reforms of the time.\(^{50}\) Distinguishing potentially viable firms from nonviable firms in such an environment was almost impossible, and it was unlikely that the legislature had superior information over either debtors or creditors to make such a determination.\(^{51}\) The immediate effect of the automatic trigger was to dramatically increase the workload of courts as well as court-appointed bailiffs, not the desired filtering of nonviable from viable firms.

Still, the automatic trigger introduced in Hungary to stimulate bankruptcy was a relatively benign measure compared to those taken


\(^{48}\) See *infra* pp. 16–18, for detailed analysis of Hungarian data.

\(^{49}\) See, e.g., Schaffer, *supra* note 8, at 88–92.


elsewhere. Although it forced debtors into bankruptcy under conditions determined by law (failure to pay debt for more than 90 days), it did not allocate discretionary power to a state agent charged with bankruptcy initiation powers, as was the case in Russia. Russia introduced its first bankruptcy code in 1992 to little effect; it resulted in only 74 bankruptcy cases brought in 1993, 231 in 1994, and 716 in 1995. Instead, firms were piling up inter-enterprise arrears as well as tax arrears, which together reached 40 percent of GDP by 1998. This outcome may have been in response to the uncertainty over the future of economic reforms in Russia. In an attempt to make the reforms more credible and to force apparently nonviable firms to exit the market, President Yeltsin established a Federal Bankruptcy Agency by decree. The purpose of this agency was to identify large companies that had become insolvent, place them under administrative management, and either salvage them or close them down eventually. Between 1998 and 2002, the agency initiated 3890 cases per year on average, or about 10 percent of all cases filed during this period. In 2002, its successor agency was authorized as the sole state agent allowed to file bankruptcy against delinquent firms. That agency, however, was formally dissolved in June 2004; its functions were then merged with the reorganized Federal Tax Services ("FTS").

Consistent with the "creditor function" of tax-authority-induced bankruptcy, there is substantial evidence that states enforced bankruptcy to increase revenue and enhance financial discipline, as well as bolster voluntary compliance with tax claims. A comparative analysis of tax arrears in transition economies documented that the stock of tax arrears in Hungary amounted to 6.9 percent of GDP in 1994, whereas in Russia, it had reached 12 percent of GDP in 1996 and close to 17 percent in 1998. Schaffer argues that the stock of tax arrears does not necessarily give rise to concern, as long as taxes are paid eventually. Of greater concern is the flow of tax liabilities that is not getting paid at all or is being written off, as that flow indicates the continuing indirect subsidization of firms, i.e. a soft budget-constraint. The best indicator for such a flow problem is an in-

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52. See Ivanova & Wyplosz, supra note 50, at 24.
54. Id. art. 2.
55. See Schaffer, supra note 8, at 98.
57. See Schaffer, supra note 8, at 97.
58. Id.
crease in the stock of tax arrears over time, as new tax arrears are added to old ones that have remained uncollected. Estimating the flow of tax arrears in transition economies based on effective statutory rates, actual tax-collection information, as well as enterprise-performance information, he finds a total of annualized flow for Hungary in the amount of 1.2 percent of GDP in 1993, and 0.7 in 1994.\textsuperscript{59} For Russia, on the other hand, the flow stood at 2.1 percent in 1994 and reached 7.3 percent in 1996.\textsuperscript{60}

To put these numbers into perspective, it is worth considering the size of the credit market in Hungary and Russia. As noted above, tax arrears were often used as substitutes for private debt finance by companies who either did not have access to the credit market, or did not want to subject themselves to the possibly more stringent enforcement practices of private creditors. These companies relied instead on state-supplied soft budget-constraints. The size of private credit-markets is commonly measured by the total claims that deposit-taking institutions hold against the private sector, divided by GDP.\textsuperscript{61} Recent data suggest that the current Hungarian credit market is 34 percent of GDP while the Russian credit market is 16 percent.\textsuperscript{62} Taking current figures as a benchmark, the total stock of tax arrears in Russia in 1998 (17 percent of GDP) was slightly larger than the private credit market, with nearly half of the arrears being accumulated rather than new. The data are less dramatic in Hungary (see Table 2 below), but nonetheless suggest that the state continues to hold important control rights over the economy.\textsuperscript{63}

Finally, there is evidence in Russia that bankruptcy has come to be used increasingly as an instrument of state control over the economy and, on occasion, as a means for reestablishing state ownership over key economic assets. The Yukos case is the most glaring example: the state seized Yuganskneftegaz (the subsidiary of Yukos) in December 2004, transferred its assets to the state-controlled Rosneft Company in February 2005, and finally liquidated Yukos in 2006.\textsuperscript{64} In addition, bankruptcy proceedings have been used by the

\textsuperscript{59} Id. at 98.

\textsuperscript{60} Id.

\textsuperscript{61} Levine, supra note 16, at 603.

\textsuperscript{62} Simeon Djankov, Caralee McLiesh & Andrei Shleifer, Private Credit in 129 Countries, 84 J. FIN. ECON. 299, 303, Table 1 (2007).

\textsuperscript{63} The flow problem was mitigated over time at least in part by reducing taxes. In particular, Russia drastically reduced its corporate tax in 2001 and introduced a flat tax of only 24 percent. However, this did not eliminate the stock problem, which was considerable. Neither did it prevent the tax authorities from claiming that tax sheltering strategies amounted to tax evasion as evidenced by enforcement actions taken. On the Yukos case in particular, see infra note 64.

\textsuperscript{64} For a full account of the use of bankruptcy law to re-nationalize Yukos, see CURTIS
tax authorities not only to enforce tax claims, but also to enforce the mandatory enterprise-registration requirement. A new law passed in 2002, "Concerning State Registration of Companies," designated the FTS as the registering organ for all companies. Failure to comply with registration requirements may result in a state agent bringing liquidation actions, according to the Russian Civil Code. In effect, the tax authorities have been empowered to close down firms that opted for the gray economy by failing to register with the state and/or to pay taxes.

In sum, there is evidence that state-initiated bankruptcy did serve various purposes. As to which was the dominant purpose in both countries, the following section will explore the political economy of state-initiated bankruptcies in Hungary and Russia in greater detail.

IV. BELL TOLLING STRATEGIES: HUNGARY AND RUSSIA COMPARED

Section III elaborated the various purposes that state-initiated bankruptcy proceedings could serve. Section IV offers a detailed exploration of the respective situations of Hungary and Russia, to determine the objective function of the tax authorities in their enforcement practice. There is relatively little evidence for the "pedagogical function" of bankruptcy in either country. In fact, the majority of bankruptcies initiated by tax authorities appear to target firms that have few assets to recover and may have already seized operations. For the remaining cases, the Hungarian tax authorities perform primarily the "creditor function": they seek to impose financial discipline and satisfy claims by liquidating firms. The main difference between the two countries is that in Russia, but not in Hungary, there is substantial evidence also of predatory enforcement by the tax authorities, which is highly selective and frequently motivated by political rather than economic reasons.

A special feature of the state acting as creditor and enforcing its tax liabilities is that the state has more extensive enforcement powers than private creditors. In theory, therefore, the tax authorities


65. Article 61 of the Russian Civil Code states the grounds on which liquidation petitions may be brought. They include irremediable violations of the law, continuous violations, and failure to comply with registration requirements, among others. Grazhdanskii Kodeks RF [GK] [Civil Code] art. 61 (Russ.).
could overcome the information disadvantage creditors tend to have vis-à-vis managers in an environment where information is costly and of low quality. Vesting the tax authorities with such powers, however, also raises the prospect of excessive tax enforcement at the expense not only of the debtor, but also of private creditors.

The extent of the tax authorities' enforcement-powers differs across countries. They are expansive and relatively unchecked in Russia, but have been more limited in Hungary, at least after the intervention of the Hungarian Constitutional Court. In 1998 Hungary enacted a law establishing a “Tax and Financial Control Administration” (the Hungarian acronym is “APEH”) with a criminal investigation department. The latter was given the power to “conduct clandestine collection of information in order to prevent and detect criminal acts falling within the sphere of criminal investigation activities.” These sweeping powers were curtailed after the Hungarian Constitutional Court deemed them unconstitutional. Still, even under the revised tax codes, tax authorities have extensive investigatory powers that include, among others, the power to enter any room that it is necessary to inspect, to examine documents, to request information from the taxpayer or his representative, and to investigate, to the extent necessary, other taxpayers in a contractual relationship with the taxpayer.

In Russia the Federal Tax Police, a specialized police force with the power to investigate criminal aspects of tax evasion, existed until recently. The Federal Tax Police had the powers to conduct inquiries into tax crimes and administrative law violations, to participate in audits at the request of tax authorities, and to carry out investigations where a crime was indicated. Although on paper these powers are not substantially different from those of the Hungarian tax authorities, in Russia there are few effective procedural controls on

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66. See Berkowitch & Israel, supra note 17, at 360.
69. See Frank, supra note 67, at 79.
70. Id.
how law enforcement agents may exercise their powers.\textsuperscript{73} The function and personnel of the Federal Tax Police have since been transferred to the Ministry of Internal Affairs, which has not diminished the sweeping investigatory powers associated with tax enforcement.\textsuperscript{74}

To assess the impact of tax authorities on firm financing, it is not only important to understand their investigatory powers, but also their powers in the context of bankruptcy, including initiation powers, priority rules, as well as their ability to impose a lien on the debtors' assets. Specifically with regards to bankruptcy, the tax authorities in both countries have the power to initiate bankruptcy proceedings. In both Hungary and Russia, this follows directly from the bankruptcy laws. Russia's lists the tax authorities as one of the state organs that can file for bankruptcy.\textsuperscript{75} In Hungary, this follows from the notion that \textit{any} creditor has the right to bring bankruptcy proceedings against an insolvent company, which includes the tax authorities, even though they are not explicitly mentioned.\textsuperscript{76} In both countries the tax authorities have the power to unilaterally attach property of a taxpayer in default and can thus initiate execution pro-

\textsuperscript{73} Evidence for this is provided by the Yukos case. The Russian tax authorities adjusted their claims whenever it suited their needs in order to ensure that the company would end up in bankruptcy, which allowed the state to get control over these assets rather than allowing the company to use future cash flow to pay back past debt. For a detailed account of the Yukos case, see \textit{Curtis Milhaupt \& Katharina Pistor, Law and Capitalism} (forthcoming 2008) (manuscript at ch. 8, on file with authors).

\textsuperscript{74} Presidential Decree, Mar. 11, 2003, No. 306 (Russ.) (ISI Emerging Markets, Garant Database), \textit{available at} \url{www.securities.com}.


\textsuperscript{76} \textit{See} Act 1L of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Voluntary Dissolution § 22 (Hung.) (ISI Emerging Markets, Hatállyos Magyar Jogszabályok database), \textit{available at} \url{www.securities.com} (hereinafter Hungarian Bankruptcy Code).
ceedings against the taxpayer's assets. However, note that tax authorities must take specific action to impose a lien and that a lien does not attach automatically when a company defaults on its tax liabilities.

A. The Case of Hungary

Hungary was one of the first of the former socialist countries to enact a bankruptcy code when it did so in 1991. Apart from the brief episode during which reorganization proceedings skyrocketed (after the introduction of the automatic trigger), liquidation has been the procedure of choice in Hungary. Since 1999, only 40 reorganizations have been filed on average in a given year. By contrast the average number of newly filed liquidation procedures per year is over 14,000. Of these liquidation proceedings, the state has been involved in a significant number. The figure given in Table 1 above on the share of bankruptcy proceedings initiated by the tax authorities (36 percent) somewhat understates the actual involvement of the state in shutting down firms. Table 1 lists only the number of bankruptcy proceedings the tax authorities filed with the courts. When looking at all liquidations, data suggest that the share of "voluntary liquidations" that resulted from tax-authority-initiated enforcement actions was substantially higher, reaching as high as 85 percent in 2001 (see Table 2).

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78. For Hungary, see id. For Russia, see Nalogovyi Kodeks [NK] [Tax Code] art. 73 (Russ.), which requires an agreement between the tax authorities and the tax subject for a pledge to arise. Note, however, that the Russian tax authorities have the power to initiate enforcement actions against a defaulting taxpayer by seizing bank accounts and property outside a court procedure. See Nalogovyi Kodeks [NK] [Tax Code] art. 46 (Russ.).
79. Note that when comparing these data with filing data in the US, reorganization appears to be very low, as by far the majority of filings in the US are for Chapter 11 proceedings. However, over 60 percent of these filings are thrown out and end up in liquidation. See Morrison, supra note 45 at 3.
Table 2: Hungarian Tax Authorities as Bell Toppers

<table>
<thead>
<tr>
<th>Year</th>
<th>Liquidation Announcements</th>
<th>Tax Authority-initiated cases as Share of Total</th>
<th>Average amount of outstanding Credits (in million Forints)</th>
<th>Average amount of outstanding Credits for Tax Authority-initiated Liquidations (in million Forints)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>2593</td>
<td>22.9</td>
<td>10.1</td>
<td>11.1</td>
</tr>
<tr>
<td>1994</td>
<td>2484</td>
<td>43.9</td>
<td>13.1</td>
<td>10.3</td>
</tr>
<tr>
<td>1995</td>
<td>2799</td>
<td>63.8</td>
<td>8.3</td>
<td>13.2</td>
</tr>
<tr>
<td>1996</td>
<td>3078</td>
<td>39.3</td>
<td>9.2</td>
<td>23.5</td>
</tr>
<tr>
<td>1997</td>
<td>3171</td>
<td>36.9</td>
<td>14.1</td>
<td>26.2</td>
</tr>
<tr>
<td>1998</td>
<td>3288</td>
<td>57.4</td>
<td>16.7</td>
<td>15.3</td>
</tr>
<tr>
<td>1999</td>
<td>3495</td>
<td>59.7</td>
<td>22.4</td>
<td>25.9</td>
</tr>
<tr>
<td>2000</td>
<td>4468</td>
<td>78.7</td>
<td>16.1</td>
<td>15.1</td>
</tr>
<tr>
<td>2001</td>
<td>5762</td>
<td>85.2</td>
<td>11.3</td>
<td>11.9</td>
</tr>
<tr>
<td>2002</td>
<td>5845</td>
<td>83.6</td>
<td>9.9</td>
<td>10.9</td>
</tr>
<tr>
<td>2003</td>
<td>7660</td>
<td>72.9</td>
<td>11.7</td>
<td>9.2</td>
</tr>
<tr>
<td>Average</td>
<td>4058</td>
<td>58.6</td>
<td>13.9</td>
<td>15.7</td>
</tr>
</tbody>
</table>

Source: APEH reports (various years).

Notably, the number of tax-authority-initiated liquidations increased substantially in the period between 1999 and 2003, even though during this period Hungary's overall economic performance had improved substantially. A plausible explanation—which is substantiated by the Tax Authorities' own annual reports—is that enforcement capacity increased. This capacity could have been used to pursue more aggressive tax enforcement or to "clean up," i.e. to force firms with years of tax-arrears to formally liquidate. There is substantial support for the latter in the data presented in Table 2. The tax authorities' recovery rates were only 0.3 percent as of 2003, which is substantially lower than the 1 percent recovered on average by other creditors—suggesting that much of the enforcement was targeted at small firms, many of which may had already ceased operating. In fact, according to the tax authorities' own accounts, four fifths of all liquidation proceedings are accelerated proceedings against firms with no assets left to distribute.80 Second, the level of outstanding claims against firms was higher for firms for which the tax authorities initiated liquidation (Forints 15.7 Mln, or the equivalent of US$2000 on average) than for all other firms (Forints 13.9 Mln. See Table 2 above). In the absence of information about the debt/asset ratio of these firms, this is not conclusive evidence that the tax authorities tended to file against higher-leveraged firms, but it might be indicative. Further support for this thesis comes from data that show

that the tax authorities have tended to pursue smaller rather than larger firms. Using legal form as a proxy for size (which can be justified on the grounds that joint stock companies tend to be larger than limited liability companies ("LLCs"), partnerships, and cooperatives), we find that the Hungarian state has been most active in pursuing relatively small firms. Tax authorities filed between 42 and 66 percent of all liquidations against limited partnerships, and close to 30 percent against LLCs. In the case of joint stock companies, tax authorities have been much more timid, initiating only 4 to 7 percent of all liquidation proceedings.

Table 3: Liquidation Proceedings by Type of Company

<table>
<thead>
<tr>
<th></th>
<th>SOEs</th>
<th>Cooperatives</th>
<th>Limited Partnership</th>
<th>LLC</th>
<th>Joint Stock Company</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>8 (1)</td>
<td>255 (45)</td>
<td>1822 (765)</td>
<td>6040 (1591)</td>
<td>824 (65)</td>
<td>171 (64)</td>
</tr>
<tr>
<td>2000</td>
<td>6 (0)</td>
<td>311 (68)</td>
<td>2907 (1477)</td>
<td>8257 (2453)</td>
<td>923 (59)</td>
<td>309 (115)</td>
</tr>
<tr>
<td>2001</td>
<td>9 (1)</td>
<td>286 (85)</td>
<td>3944 (2267)</td>
<td>10008 (2937)</td>
<td>789 (47)</td>
<td>421 (210)</td>
</tr>
<tr>
<td>2002</td>
<td>9 (4)</td>
<td>250 (78)</td>
<td>4196 (2647)</td>
<td>10384 (2802)</td>
<td>788 (43)</td>
<td>335 (153)</td>
</tr>
<tr>
<td>2003</td>
<td>9 (0)</td>
<td>209 (56)</td>
<td>4888 (3249)</td>
<td>10369 (2952)</td>
<td>879 (40)</td>
<td>364 (164)</td>
</tr>
</tbody>
</table>

Note: Numbers in parentheses indicate the number of liquidation proceedings that were initiated by state agents.

Source: APEH

To summarize, in Hungary tax authorities play an important role in determining the ultimate fate of firms, particularly of small and medium-size firms. On average, tax authorities initiated 58 percent of all liquidations announced between 1993 and 2003. This evidence suggests that the state plays a crucial role in enforcing financial discipline, particularly against small firms (see Table 2 above). This may be interpreted as evidence that the state is more likely to tolerate a soft budget constraint for larger firms. However, it may also suggest that smaller firms, which by comparison lack access to outside credit markets, are more highly leveraged and accordingly are more likely than large firms to rely on tax arrears as sources of credit. In any case, there is little evidence in these data that the Hungarian tax authorities are using their increased enforcement capacity to pursue larger targets in an attempt to re-nationalize assets, or for other predatory purposes.
B. The Case of Russia

Russia enacted its first bankruptcy law in 1992, which went through major revisions in 1998 and then again in 2002. Under all three variants of Russia’s bankruptcy law, bankruptcy proceedings could be initiated by the debtor, the creditor, or an organ of state power. The 1998 law explicitly named the tax authorities as well as “other authorized organs of state power” as potential bankruptcy initiators. A government decree, however, designated the Federal Service of Russia for Financial Recovery and Bankruptcy (FSFO) as the relevant body to represent the state in bankruptcy proceedings. Its powers were further strengthened after the enactment of the 2002 Insolvency Law, when it acquired the status of the exclusive representative of the state’s interests in bankruptcy. Yet, in 2004 this agency was abolished and its functions were merged with the reorganized FTS, which thereby became the exclusive body to represent the state in bankruptcy cases.

As noted above, the market response to the first enactment of a bankruptcy law was rather muted, since only a few creditors took action. Bankruptcy proceedings increased in the mid 1990s—in part because changes in the bankruptcy law empowered creditors, and in part because of tightened economic conditions that resulted after inflation was finally brought under control. Newly filed bankruptcy cases further accelerated after 2000, with a new peak of over 100,000 cases filed in 2002 (see Table 4 below). By 2003, numbers were back to about 14,000 new filings per year.

82. See 2002 Federal Law on Insolvency, supra note 44.
83. 1998 Federal Law on Insolvency, supra note 75 art 6.2.
84. See Government Decree on Bankruptcy and Financial Sanitation, supra note 75.
Table 4: Who Tolls the Bells for Firms in Russia?

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>BKR Initiated by Debtor</td>
<td>2,600</td>
<td>3,097</td>
<td>3,476</td>
<td>4,654</td>
<td>4,925</td>
<td>5,380</td>
</tr>
<tr>
<td></td>
<td>(20.7)</td>
<td>(20.7)</td>
<td>(14.8)</td>
<td>(8.4)</td>
<td>(4.6)</td>
<td>(40.6)</td>
</tr>
<tr>
<td>Private Creditors only</td>
<td>3,170</td>
<td>3,435</td>
<td>4,726</td>
<td>5,289</td>
<td>7,122</td>
<td>2,920</td>
</tr>
<tr>
<td></td>
<td>(25.3)</td>
<td>(22.9)</td>
<td>(20.2)</td>
<td>(9.3)</td>
<td>(6.7)</td>
<td>(22.0)</td>
</tr>
<tr>
<td>Tax authorities</td>
<td>4,037</td>
<td>5,922</td>
<td>10,865</td>
<td>37,767</td>
<td>87,634</td>
<td>4,963</td>
</tr>
<tr>
<td></td>
<td>(32.2)</td>
<td>(39.6)</td>
<td>(46.2)</td>
<td>(68.0)</td>
<td>(82.3)</td>
<td>(37.4)</td>
</tr>
<tr>
<td>Federal BKR Authority</td>
<td>2,033</td>
<td>1,660</td>
<td>3,603</td>
<td>6,631</td>
<td>5,526</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(16.2)</td>
<td>(11.1)</td>
<td>(15.3)</td>
<td>(11.9)</td>
<td>(5.2)</td>
<td></td>
</tr>
<tr>
<td>Other State</td>
<td>713</td>
<td>859</td>
<td>840</td>
<td>1,171</td>
<td>1,273</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(5.7)</td>
<td>(5.7)</td>
<td>(3.6)</td>
<td>(2.1)</td>
<td>(1.2)</td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>12,553</td>
<td>14,973</td>
<td>23,510</td>
<td>55,512</td>
<td>106,480</td>
<td>13,263</td>
</tr>
</tbody>
</table>

Note: Numbers in brackets indicate share of total.
Source: Russian Supreme Arbitrazh Court from unpublished sources.

Closer inspection of the data reveals that the rise of the state as bankruptcy initiator may be somewhat less dramatic than Table 4 suggests, even though it is still substantial. A sizeable share of all bankruptcies filed were accelerated procedures against so called “absentee debtors,” i.e. those that had not registered or filed their taxes for a number of years. In fact, 81,251 of the bankruptcy cases filed in 2002, when the total came to 106,647 (or 76 percent), were filed against such absentee firms. This was the first year that the tax authorities kept the company register, and suggests that they brought a large number of bankruptcy cases simply to clean up their books and the company register. It also indicates that the tax authority was taking its new role as company registrar and enforcer of mandatory registration requirements quite seriously. Still, even when discounting these cases the share of bankruptcies brought by the state dwarfs those brought by debtors or private creditors (see Table 5 below).

Table 5: BKR Filings in Russia without Absentee Debtors

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>BKR Initiated by Debtor</td>
<td>2,600</td>
<td>3,097</td>
<td>3,476</td>
<td>4,654</td>
<td>4,925</td>
<td>5,380</td>
</tr>
<tr>
<td></td>
<td>(18.5)</td>
<td>(21.2)</td>
<td>(20.4)</td>
<td>(19.5)</td>
<td>(17.3)</td>
<td>(48.3)</td>
</tr>
<tr>
<td>Private Creditors only</td>
<td>3,170</td>
<td>3,435</td>
<td>4,726</td>
<td>5,289</td>
<td>7,122</td>
<td>2,920</td>
</tr>
<tr>
<td></td>
<td>(22.5)</td>
<td>(23.5)</td>
<td>(27.8)</td>
<td>(22.1)</td>
<td>(25.0)</td>
<td>(26.2)</td>
</tr>
<tr>
<td>All State (Tax, Fed BKR, Other)</td>
<td>8,319</td>
<td>8,083</td>
<td>8,797</td>
<td>13,977</td>
<td>16,457</td>
<td>2,834</td>
</tr>
<tr>
<td></td>
<td>(59.0)</td>
<td>(55.3)</td>
<td>(51.8)</td>
<td>(58.4)</td>
<td>(57.7)</td>
<td>(25.5)</td>
</tr>
<tr>
<td>TOTAL</td>
<td>14,089</td>
<td>14,615</td>
<td>16,999</td>
<td>23,920</td>
<td>28,504</td>
<td>11,134</td>
</tr>
</tbody>
</table>

Note: Share of total is given in parentheses.
Source: Russian Supreme Arbitrazh Court from unpublished sources.
The data show that the state, and in particular the tax authorities, were responsible for more than 50 percent of all bankruptcy filings in each year since 1998, except for 2003, when the share dropped to only 25.5 percent. This decrease may have been a direct response to the backlog triggered by aggressive filings in the preceding year. According to statistics released by the Supreme Arbitrazh Court of the Russian Federation, in 2003 courts of first instance decided 56,440 bankruptcy cases—an increase of 27 percent over 2002. The number of decided cases dropped to 20,116 cases in 2004 and further to 18,812 in 2005, but reached an all-time high in 2006 with 60,848 cases. Although the identity of the bankruptcy initiator is not available for these more recent years, there is little doubt that the tax authorities are continuing to play a major role in bringing firms into bankruptcy. In fact, the FTS has brought action with the Russian constitutional court demanding that the statute of limitation for past tax liabilities be relaxed. This would allow for the enforcement of tax liabilities dating back to the early 1990s, when tax arrears skyrocketed.

There is also some indication that the Russian tax authorities are more aggressive in enforcement against larger firms. As noted above, in Hungary the average debt of firms against which the tax authorities foreclosed was about US$2000, and the recovery rate against these firms was 0.03 percent (or US$60). Contrast this with the Russian authorities' claims of collecting R 2000 bn (US$72 mln) for the 2004 budget (much of which can be attributed to the enforcement actions against Yukos). Using 2003 bankruptcy data, this would suggest a recovery of, on average, US$2000 per firm. Moreover, Anatoly Serdyukov, the head of the Russian Tax Service claimed in interviews that the tax authorities were involved in 47,000 bankruptcy cases and contemplating another 17,000, with a major goal of these proceedings being to generate funds for the state


87. Id. Data on the size of companies that have been targets of state initiated bankruptcies are also not available. However, there are some indicators that the bulk of companies that have been liquidated or auctioned off as the result of enforcement actions are not marginal players in the economy. Available data single out state owned enterprises, monopoly companies, farmers, and individual entrepreneurs, among others, to assess the impact of bankruptcy on the economy. These companies, taken together, account for only 9 to 14 percent of all bankruptcy cases in a given year.

88. This calculation obviously overstates the likely recovery rate, as it uses only bankruptcy cases, not other tax enforcement actions.
This suggests that even though the majority of enforcement actions are being brought against absentee firms, the tax authorities are not shy in taking on large companies, where—given the larger asset base of firms—recovery rates tend to be higher. This is further supported by anecdotal evidence, such as the Yukos case, and recent enforcement actions initiated against companies with foreign investments, such as VimpelCom, Norway’s Telenor, and JT International, a unit of Japan Tobacco.

On the positive side, the state of Russia’s tax arrears improved considerably since Putin has come to power. While in 1998 the amount of past tax arrears equaled 91 percent of all tax obligations, by 2003 this number had declined to only 42 percent. Curiously, during the same period, corporate tax arrears as a share of total arrears increased from only 16.5 percent in 1998 to 42.9 percent in 2002, although it declined again to 32.3 percent in 2003. This evidence suggests that while tax discipline has improved in general, tax discipline in the corporate sector has not, and may even be declining—notwithstanding the tax authorities’ aggressive enforcement practices. This is in spite of tax reform, which introduced a flat corporate tax of only 24 percent in 2001. In fact, the nominal value of corporate tax arrears is still almost double of what it was in 1998 (Table 6 below).

Table 6: Tax Arrears in Russia

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Obligations</td>
<td>259</td>
<td>371.6</td>
<td>461.7</td>
<td>475</td>
<td>521.8</td>
<td>520.4</td>
</tr>
<tr>
<td>Payments past due</td>
<td>235.6</td>
<td>335.7</td>
<td>354.2</td>
<td>237.7</td>
<td>209.6</td>
<td>220.8</td>
</tr>
<tr>
<td>Past due as share of Tax Obligations</td>
<td>91.0</td>
<td>90.3</td>
<td>76.7</td>
<td>50.0</td>
<td>40.2</td>
<td>42.4</td>
</tr>
<tr>
<td>Corporate Tax arrears</td>
<td>38.8</td>
<td>69.0</td>
<td>91.0</td>
<td>88.3</td>
<td>88</td>
<td>71.4</td>
</tr>
<tr>
<td>Corporate tax arrears as share of all arrears</td>
<td>16.5</td>
<td>20.6</td>
<td>26.9</td>
<td>37.2</td>
<td>42.9</td>
<td>32.3</td>
</tr>
</tbody>
</table>

Source: Goskomstat (various years).


C. Summary

As the foregoing suggests, neither Russia nor Hungary seems to make use of the pedagogical function of bankruptcy. Instead, when tax authorities initiate bankruptcy proceedings they seem to target firms that have few assets remaining, and whose operations the tax authorities have already seized. In the few cases which buck this trend, the Hungarian tax authorities seemed primarily to perform a "creditor function," by using bankruptcy proceedings to impose financial discipline and to satisfy outstanding claims by liquidating the firm. As the data suggests, Hungary and Russia differ to the extent that in Russia, but not in Hungary, tax authorities seem to engage in predatory enforcement that is highly selective and appears politically motivated.

V. DEBT FINANCE IN THE SHADOW OF THE TAX AUTHORITIES

This Section explores the likely impact the presence of the tax authorities has on a firm's debt structure. It first considers how the presence of tax authorities as creditors affects incentives for private creditors of the same debtors. The argument put forward is that from a theoretical perspective the outcome is ambiguous. Tax enforcement may increase overall financial discipline. However, when firms are already highly indebted to tax authorities, a shift from weak enforcement by tax authorities to strong enforcement may lower the incentive of private creditors to lend to firms, at least on an unsecured basis. This Section then considers how tax enforcement may improve the situation of private creditors. My chief insight here is that private creditors may piggyback on enforcement activities of tax authorities. Without spending substantial resources on monitoring debtors, they can rely on the tax authorities disciplining creditors.

As Desai et al. suggested, in every taxed firm the tax authorities are an important, albeit understudied, stakeholder.\(^ {91}\) While agreeing with this basic proposition, this essay argues that the role of the tax authorities is only incompletely described as equity-holder and instead more akin to the holder of a convertible-equity claim, i.e. an equity claim that automatically converts into a credit claim once the firm defaults on its taxes. Contrary to Desai et al., this essay argues that the presence of the tax authorities thus has implications not only for shareholders, but also for creditors of the firm. To place this

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91. See Desai, supra note 18, at 592.
analysis in the broader analysis of bankruptcy and debt finance, this section first summarizes some of the recent theoretical literature on bankruptcy and debt finance.

The bankruptcy literature has shown that a firm's debt structure is influenced in important ways, not only by the bankruptcy regime, but also by the number of creditors a firm has. Economists Dewatripont and Maskin distinguish between centralized and decentralized credit markets, where the level of centralization is determined by the number of capital providers. They suggest that the likelihood that a project will be refinanced at a later stage in large measures determines the ex ante decision to finance a particular project. In the presence of multiple creditors, refinancing becomes more difficult, mostly as a result of the coordination problems among them. On the positive side, this coordination problem serves as a commitment device at the ex ante stage not to refinance nonviable projects in the future, thereby reducing the costs of debt finance.

Following this basic intuition, economists Bolton and Scharfstein model a firm's optimal debt structure as being contingent on the number of the creditors this firm has. They suggest that the relative costs and benefits of having multiple creditors depend on the likely cause of insolvency: liquidity or strategic default. Liquidity default means that a creditor does not have the cash to pay its debt obligations as they become due. Strategic default means that the firm's manager diverts firm assets to himself rather than using funds to fulfill the firm's debt obligations. Facing the possibility of strategic default, creditors may be unwilling to lend. In order to optimize their ability to obtain external debt finance, firms with low credit quality should choose a single creditor and grant security interests only to that creditor. This maximizes the creditor's liquidation value and thus lowers the firm's cost of debt finance. Firms with high credit quality, by contrast, should borrow from multiple creditors, as this reduces the likelihood of strategic default. This follows from the intuition that firms will have to pay more to fend off a liquidation

96. Id. at 2.
97. Id.
98. Id.
threat by multiple creditors because each creditor that forecloses against the firm's assets must be bought off to increase the firm's value. By implication, a firm with multiple creditors is less likely to stage a strategic default.

Berglöf et al.\textsuperscript{99} take the analysis a step further. Fully endogenizing the need for a bankruptcy regime, they show that the probability of strategic default may actually increase rather than decrease in the presence of multiple creditors. The reason has to do with the fact that firms with multiple creditors are often over-leveraged.\textsuperscript{100} While each individual claim may be fully enforceable, the sum of claims is mutually inconsistent. This increases the incentive for strategic default. The function of bankruptcy law thus is to make creditor claims consistent at the \textit{ex post} stage.

The analysis presented here builds on the important insight that the probability of and the reason for default, in large part, determine the choice of a firm's debt structure. As Bolton and Scharfstein have shown, the number of creditors and the allocation of security interests among them may influence the probability of strategic default.\textsuperscript{101}

The contribution of this essay is to suggest that all firms subject to taxes have more than one creditor (the state, as a public creditor, in addition to any private creditors), but that public and private creditors may differ in important ways and at times have conflicting interests. This may affect private creditors both negatively and positively. On the negative side, the presence of the tax authorities as substantial creditors may crowd out private creditors. On the positive side, for firms that have not accumulated substantial tax arrears, the presence of tax authorities as 'convertible-equity holders' may increase financial transparency and may help overcome coordination and information problems that dispersed private creditors might face.

\textit{A. Contracting in the Shadow of the Tax Authorities}

When a firm pays its taxes as they become due, the tax authorities have an equity type claim against the firm. They receive a substantial share of the firm's profits without exercising voting rights or other procedural rights typically associated with equity claims. Once the firm defaults on its taxes, however, this claim converts into a debt claim, typically with additional enforcement powers attached

\textsuperscript{99} See Berglöf et al. \textit{supra} note 93.
\textsuperscript{100} Id. at 3.
\textsuperscript{101} See Bolton & Scharfstein, \textit{supra} note 95, at 19–20.
to it. Depending on the relevant laws in place, the tax authorities may exercise even greater powers than an ordinary creditor.

In particular, the tax authorities may unilaterally create a lien over the firm’s assets; in some jurisdictions such a lien is automatically created upon default. Alternatively, the tax authorities may initiate enforcement actions outside court, as is the case in Russia. Moreover, even without securing their claims, tax authorities typically have priority over the claims of unsecured creditors. This is the case both in Russia and in Hungary. Specifically, the priority rules of the 1998 Russian bankruptcy code provides that claims of the state, including the tax service, would be satisfied after secured creditors, but prior to unsecured creditors. Similarly, the 1993 Hungarian Bankruptcy Law provides that unsecured tax claims are satisfied prior to all other unsecured creditors. Finally, the tax authorities’ objective function differs from that of private creditors. In particular, they may be less willing to refinance a firm, even if it would enhance the repayment likelihood of past arrears, because refinancing may undermine tax compliance. In the interest of general tax compliance, tax authorities are therefore more likely than private creditors to “toll the bells for firms” that could still be viable. This may enhance the commitment device at the ex ante stage.

Private creditors of the firm are safe to ignore any claims of the tax authorities as long as the firm does not default on its tax. Without a tax default, interest is paid from gross income, ensuring that private creditors get paid before tax authorities realize their “equity” claim. Naturally, when a firm defaults on its tax, private creditors do not benefit from the additional liquidity in the same way equity holders might benefit.

The private creditors’ cost-benefit analysis changes, however, once a firm has defaulted on its tax obligations. At this point, the tax authorities can take enforcement actions, including liquidation actions in a bankruptcy proceeding. Senior secured creditors are not harmed, as their claims will usually be satisfied prior to those of the tax authorities. Unsecured creditors, however, may be squeezed out by the tax authorities’ enforcement actions. Therefore, if private creditors expect the debtors to default on their taxes they should secure their claims—which increases the cost of debt finance.

The key question for creditors in transition economies is

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102. Russian Tax Code, supra note 72, art. 46(2) (tax authorities can forward a cash collection-order to the bank of the taxpayer or tax agent, ordering the bank to withdraw funds from the account).
104. Hungarian Bankruptcy Code, supra note 41, art. 57(1).
whether to lend to firms that have already accumulated tax arrears. Suppose the tax authorities were only another private creditor. If a firm were already highly leveraged, a new creditor would be reluctant to lend to that firm, and would do so only if she could secure her claim and/or charge a substantial premium. The same reasoning applies, in principle, to a situation where the tax authorities are the senior creditors. However, the equation is influenced by the effectiveness of tax enforcement and the objective function of the tax authorities, in particular whether they are predators or simple claim enforcers. Where tax enforcement is lax, creditors might ignore past arrears. The risk they face is that enforcement practices might change in the future and that past tax liabilities may trigger the insolvency of a firm that would otherwise be viable. The implications are clear: in an economy with a history of tax arrears, creditors may be reluctant to lend to firms, and if they do lend, only at additional costs to the firm.

This reluctance of private creditors to lend is likely to increase when a country moves from a weak enforcement state to a high enforcement one, as happened in Russia under Putin. While the probability of being targeted by the tax authorities may not be high for every firm in the economy, the effects of enforcement actions could be disastrous for the firms and their creditors, as suggested by the Yukos case. In this case, the state was able to recover its tax losses (and perhaps even more). By contrast, private creditors of the company, including foreign creditors, are still fighting to realize their claims.

This suggests that the accumulation of tax arrears may have impeded the development of private credit markets in the transition economies. These countries confronted a dilemma. Creating a viable tax regime was important to generate revenue and, according to Desai et al., could under certain conditions improve financial discipline. However, in the early days tax authorities were too weak to enforce compliance—and compliance was “naturally” low because the firms did not have a history of paying taxes voluntarily. Moreover, because private credit markets had not yet developed, firms had little choice but to shift to other sources of funds, including nonpayment of tax obligations. Over time, tax authorities became more ef-

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105. See generally MILHAUPT & PISTOR, supra note 64.
107. Desai et al., supra note 18.
fective and began to collect more systematically. This, however, created additional uncertainties for private creditors, who had to reckon with enforcement actions for past tax liabilities. Thus, the presence of the tax authorities as a major creditor in many transition economies may help to explain why private credit markets have been slow to develop. In fact, credit markets in transition economies tend to be smaller than those of countries with similar levels of GDP, even though firms in transition economies prefer credit markets to the less well-developed equity markets. Moreover, surveys of firms in the region suggest that access to external finance remains difficult for most—this being despite the fact that the banking sector has been reformed substantially and that legal protections for creditor rights have been put into place.

A possible solution to this dilemma is a tax amnesty for past arrears. Although there is a moral hazard problem, establishing some enforcement precedents should suffice to signal a general change in policy. In fact, in Russia pressures have mounted to declare a general tax amnesty for past tax arrears in the aftermath of the Yukos trial. Such an amnesty would eliminate the uncertainty of tax enforcement for both firms and creditors. After the tax authorities have demonstrated their capability and willingness to enforce claims for tax arrears, the danger of moral hazard is relatively low.

B. Tax Enforcement and Financial Discipline

In their paper on tax and theft, Desai, Dycke, and Zingales argue that state-imposed and state-enforced taxes can have the beneficial effect of reducing corporate theft and enhancing shareholder value. They build their argument in part on historical evidence in the United States, where corporate taxes introduced in 1909 were initially levied at only 1 percent of profit. The explicit purpose of this tax was not to create revenues for the state budget, but for the state to better monitor firms and prevent theft. They also found support for their argument by analyzing the effect of improved tax enforce-
ment on share value in Russia after Putin came to power.\textsuperscript{113}

By contrast, this essay focuses on the cost of debt rather than equity finance. As the economists Rajan and Zingales have shown, in many countries, including in the United States, debt finance is more important as a source of external finance than equity finance.\textsuperscript{114} In transition economies, this pattern appears to be even more pronounced. Only a few firms have issued equity securities\textsuperscript{115}—notwithstanding attempts to jump-start stock market development through mass privatization. Instead, most firms rely on retained earnings, and those that have recourse to external sources of finance tend to rely on debt rather than equity.\textsuperscript{116}

This raises the question of whether corporate taxation and enforcement (as may be suggested by the analysis so far) are only detrimental for debt finance by private creditors, or whether they could potentially have beneficial effects as well. Recall that creditors face two major problems when confronting nonpayment. First, they face an information problem, as they may have difficulties discerning temporary illiquidity from insolvency. Second, creditors face a coordination problem, in that each creditor benefits from enforcing her claim unilaterally, but collectively they gain from a bankruptcy procedure. The tax authorities' extensive enforcement powers, including the power to visit the premises of debtors and collect information on the firm outside of any court procedures may help address the information problem—provided, of course, that the tax authorities have sufficient capacity. Moreover, even if the tax authorities preferred to enforce unilaterally rather than collectively, the aggressive enforcement of tax claims may induce the debtor to seek protection in bankruptcy. As noted before, a large number of the supposedly "voluntary" bankruptcy filings of small and medium size firms in the US seem to follow precisely this pattern.\textsuperscript{117} Thus, the presence of the tax authorities may improve financial discipline, thereby reducing the cost of debt finance.

There is another way in which tax authorities may positively influence private debt finance. As suggested by Dewatripoint and

\textsuperscript{113} Id.
\textsuperscript{117} See Baird & Morrison, supra note 24, at 2316.
Maskin,\textsuperscript{118} and Bolton and Scharfstein,\textsuperscript{119} the cost of debt finance will depend on the ability of creditors to protect themselves against strategic default on the one hand, and against the likelihood that bad projects will be funded at the refinancing stage, on the other. Turning to the latter problem first, the presence of the tax authorities is likely to reduce the probability of refinancing and strengthen the \textit{ex ante} commitment device not to refinance bad projects. This follows not only from the fact that, in the presence of the tax authorities, few firms have only a single creditor. It is also related to the objective function of the tax authorities. As noted already, tax authorities will seek to maximize their returns with regards to a single firm while seeking to enhance overall tax compliance. Liquidating some potentially viable firms may therefore be a reasonable cost to incur from their perspective. The major danger, of course, is that they will exit firms that private creditors deem to be viable.

Regarding the strategic default problem, the same argument can be made for debtors that Desai et al. have developed for minority shareholders, namely that tax enforcement enhances transparency.\textsuperscript{120} The imposition of corporate taxes ensures at least a modicum of financial accounting, which benefits not only tax authorities, but also other stakeholders by making it more difficult to steal assets. The major caveat to this argument is that tax authorities may in fact have fewer resources to disentangle complex accounting structures and tax avoidance schemes than private investors.

\section{VI. Conclusion}

In this essay, I sought to investigate when and how firms exit the market in transition economies. I began by asserting that in most economies, exit decisions are taken not by firms, but rather on behalf of firms, and that important insights might be gained from understanding which stakeholders control the exit decision in different economies. Data from transition economies suggest that the tax authorities play an important, and at times dominant, role as creditors in these countries. This prompted an analysis of the impact the presence of the tax authorities may have on the debt structure of firms. I argued that, in the context of transition economies, improved tax enforcement can have detrimental effects for creditors, especially in countries where firms had already accumulated substantial tax ar-

\begin{itemize}
\item \textsuperscript{118} See Dewatripont & Maskin, \textit{supra} note 94, at 555.
\item \textsuperscript{119} See Bolton & Scharfstein, \textit{supra} note 95, at 20.
\item \textsuperscript{120} See Desai et al., \textit{supra} note 18, at 595.
\end{itemize}
rears. Stronger enforcement measures may challenge the viability of these firms, even though future cash flow predictions might be positive. Moreover, where—as in Russia—there is reasonable fear that enforcement action may be arbitrary, if not predatory, private creditors may choose not to take any risks in the future. However, the argument I develop in this essay has implications beyond transition economies, with their unique history of state control of the economy and a transformation process marred by absent or ineffective legal institutions. Tax authorities are dormant creditors of virtually all firms, in any economy. When and how they use their rights as creditors is therefore critical for understanding the role of the state in the economy as well as in the operation of credit markets. As argued by Desai et al., the presence of the tax authorities may have been critical for promoting greater transparency of financial accounting, with positive spill-over effects for private shareholders. Similarly, private creditors may benefit from the state-as-creditor because the tax authorities may strengthen the commitment to enforce against delinquent debtors.

This is not an argument in favor of high taxes or a strong presence of the state in private firms. It merely suggests that the state does play a much larger role as a stakeholder in firms than is typically assumed in corporate governance and bankruptcy literature. Given the presence of this stakeholder, it seems important to understand how exactly it affects the governance and financing of such firms.

121. Note that private creditors of Yukos have still not found relief for their claims, which were ignored when Yukos was liquidated and its assets transferred back to state ownership. They sued outside Russia, however, and in 2007 a Dutch court deemed the bankruptcy of Yukos void under Dutch law. See Dutch Court Voids Yukos Bankruptcy in Netherlands, Reuters, Oct. 31, 2007, available at http://www.robertamsterdam.com/2007/10/dutch_court_voids_yukos_bankru.htm (last visited April 10, 2008).

122. See e.g., Desai et al., supra note 18.