Blacklisting in Russian Public Procurement: How it Doesn't Work

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Abstract
The main goal of the reform of public procurement in Russia, initiated in 2005, was to prevent corrupt
deals between suppliers and procurers. That is why the public procurement law favors formal
mechanisms to govern most of the stages of procurement: the procurer is not allowed to take into
account the reputation of the supplier when he announces call for bids and selects the supplier, and he
is prescribed to use legal system (courts) if he is not satisfied with the contract performance. As the
efficiency of formal institutions is not very high, these mechanisms are complemented with the
«formalized informal instruments» - blacklisting of opportunistic suppliers, which is believed to
substitute for reputation mechanisms to support formal mechanisms when they are weak. In the paper
we show how and why institutional environment in Russia makes the blacklisting of opportunistic
suppliers irrelevant. We explore how the share of contract breaches in total number of signed contracts
depend on corruption and transparency measures for Russian regions. We also argue that such factors
as measurement costs, verification costs, length of contract and an amount of the suit influence on the
probability to win the process on breached contract.

How to choose a fair supplier? How to insure contractual hazards? It is common questions to all
customers and public procurers are not an exception. Information asymmetry is a wide spread in
contractual relations, usually the supplier knows better whether he is going to deliver high quality
goods on time or he is going to take money and disappear. One of the powerful tools to solve such
situations is reputation. One of the first papers about the role of reputation in economic transactions is
by Klein and Leffler (1981). They show under which conditions the market mechanism could be used
as an enforcement mechanism in infinitely repeated transactions. The basic idea of reputation
mechanism is that the value of potential future transactions forcing parties not to deviate their
present obligations. The reputation mechanism is one of the cheapest tools to enforce contractual obligations.

Greif (1993, 1994) in his famous works about Maghribis and Genoese traders treats reputation as a
history of interactions. Reputation works only if all members of community are willing to punish
deviators. Each member expects that trader wouldn’t make a deal with unfair agent. In such set up to be
unfair is costly strategies and this stimulates agents not to deviate. Maghribis based their behavior on
collectivist strategy and used widely history of interactions as an informal reputational mechanism.
Blacklisting is a formalized informal institution. It is an analogue of history in the medieval trade. The
only difference is that traders were interested by themselves in history formation and public buyer is
forced to put information on the list by the law. It is common practice to make blacklist free to public.
This allows customers to share quickly information about unfair firms. Netethelss there are some
open question about blacklist. These questions are who can enter the list and what is the reason?
Blacklist is official mechanism and it could highly influence firm’s performance. So in one hand state

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is interested in easy process to put unfair firms into the list, but from the other hand it should provide safeguards to firm. It is worth to confirm that there was opportunistic behavior. That’s why blacklist is highly depend on court system and its effectiveness. "the effectiveness of blacklisting is also limited in many ways, depending on how much effort and expense a country is willing to put into the blacklisting process and whether the blacklisting depends on a conviction or not". (Sope Williams, 2010, p.148)

**What is going on in Russia?** Russian public procurement law (FL-94) relies on the state regulation and the judicial system. In order to evaluate the effectiveness of these mechanisms, we used indicator calculated by the World Bank. The indices are constructed so that the higher the index value, the better corresponding institutions work in the considered country. The maximum value of each indicator is 100. As we have seen (see Appendix 1, Figure 1.1) throughout the period of calculating the indicators of Russian institutional environment do not show satisfactory values. Moreover, Russia has failed in any of the indicators to rise above 50 points. Particular attention should be paid to the value of the indicator "Rule of Law." The system of federal public procurement requires extensive use of the legislative sphere, which, according to international observers, is poorly developed.

Unfortunately, we have to state that in Russia, according to World Bank data, there are serious problems in the judiciary, and state regulation. This means that many of the mechanisms offered by the FL-94 for the suppliers and customers, in practice do not always work well, and their use may be associated with a number of problems. Evidence of an inefficiency of judicial system is the reluctance of participants of the public procurement system to bring a suit in the court, even when their rights have been violated. Perhaps this is one of the reasons that the majority of breached contracts terminated by entering into a voluntary agreement between the parties (see Table 2).

Existing Russian procurement law (94 FL) was introduced in 2005. According to it buyers may use open tenders, open auctions, sealed bid auctions (price quotations), and negotiations. The choice of public procurement procedure depends primarily on the maximum price of the procurement. The negotiations can be chosen only for small purchases, and only once in three months for similar purchases, so as not to create incentives to split large procurements into smaller contracts. Though the recent trend indicates the growing number of contracts awarded through negotiations, it is not regulated by 94FL. The rules for the first three procedures are set in 94 FL, including the requirements for the publishing of information at the web sites. The requirements for open tenders and open auctions are quite similar, the rules for sealed bid auctions are less strict. The crucial point is priority of open auctions. Government recommends all authorities to use open auction to purchase goods and services. Current auction procedure does not allow to take into account characteristics of potential suppliers, the choice should be based only on price.

The only formal reputational mechanism that is provided to the participants of public procurement is blacklist. If the firm is listed there, the customer has the right to exclude her from bidding. The participants of the procurement procedures have two opportunities to use third party to enforce fulfillment of commitments. Suppliers could complaint to Federal Antimonopoly Agency (FAS) if the procedure was organized with violations. Even if FAS satisfies complaint violator is not included to blacklist. The buyer could go to court if contract obligations are not fulfilled. And only in the case of positive court decision supplier enters the blacklist.

**How blacklist works by law in Russia.** The principles of the registry unscrupulous suppliers are enshrined in the Statute of maintenance the register of unscrupulous suppliers and the requirements for
engineering, software, linguistic, legal and organizational means to ensure maintenance of a register of unscrupulous suppliers (approved by RF Government Decree of 15 May 2007 N 292). We will call it blacklist. According to the Regulations blacklist is managed by the Federal Antimonopoly Service (FAS), based on data submitted by state customers. Customers should report to FAS about inappropriate implementation of obligations by suppliers. Register is maintained in electronic form (http://rnp.fas.gov.ru/) and FAS gives free access to everyone.

Who can get into the blacklist? There are two reasons why the supplier enters into the blacklist: the supplier has refused to sign the contract for bidding won by them, the supplier has performed the contract with "material breach".

"The concept of definition "material breach" is set forth in paragraph 2 clause 2 article 450 of the Civil Code of Russian Federation: A violation of a contract by one party, which leads to the other party to such damage, it is largely deprived of what was entitled to expect at the conclusion of the agreement. "(Definition taken from legal information and educational portal “Everything about Law” http://www.allpravo.ru/library/doc2264p0/instrum4904/item4911.html)

In order to include unfair supplier into the blacklist customer must provide the FAS package of documents containing information about the supplier and confirmation that the violation of the law took place. To collect all documents the customer should spend his time. And here is the most difficult moment - is there any incentives for customers to provide information on unscrupulous suppliers? The customer in public procurement system does not receive residual rights, so here it is worth to have enforcement system.

The supplier enters the list as many times as information about breached by him contracts were sent, and he is located in the list for 2 years from the date of inclusion.

However, the length of update period allows unscrupulous firm to get a high enough rent from the misconduct. The rules of keeping the list fix, that information must be submitted no later than 3 days from the date of termination of the contract, and FAS should include this information into the list within 3 days. Accordingly, a maximum of 7 days must elapse from the date of termination.

Here we sum up some facts that we should have in mind speaking about blacklist:

1) We should keep in mind that there are some amount of breached contracts that haven’t been included in the list. This number could be quite big due to low popularity of judicial system as a resolution mechanism and due to the condition of material breach of contract.

2) The average period of inclusion unfair suppliers into the list is higher than the period fixed by the law. By the law it should took less than 7 days to include unfair supplier into the list, but in practice average period is 84 days. This allows unscrupulous firms to cheat several customers.

3) The list is maintained inaccurately and contains errors that could mislead its users.

4) The majority of entries in the list are situations when the supplier refused to sign a contract, and among the breached contracts the majority of entries are situations when customer cannot avoid going to court (the contract is concluded, but the goods are not delivered or supplied in part).

5) The information presented in various official sources (blacklist from FAS, the general statistical information according to the Federal Statistics Service, the regional government procurement sites) does not match.
So one of the question – how this institution works in different regions? Are there any differences in the demand for this institution? How we could explain this. We suppose that usage of blacklist should be correlated with the transparency of information in the region. The more transparent is the regional procurement system the higher the demand for black list.

The second question deals with inner problems of this institution. We look at the factors which determine the probability to win with minimal costs. It is common knowledge that ability to write down a complete contract depends on the type of good. There are no complete contract in real world, but we can identify three types of good following Nelson (1970), Darby and Karny (1973) associated with three levels of difficulty to fix all details in the contract. They are search, experience and credence goods (see more detailed description in section Empirical results). The idea was that goods differ in ability to identify the quality. This is correlated with ability to specify quality in the contract. It is easy to fix details for search good and very hard for credence goods. Serious problems usually occur with credence goods and with the questions of quality. For goods and services with high measurement costs of quality demand on special resolution mechanisms is higher compare with simple standardized goods. According to Russian procurement system blacklisting supposed to be such a mechanism. But we showed that for the credence goods it doesn’t work so good as expected.

Transparency and blacklisting

**Hypothesis 1:** We argue that corruption, transparency and gross regional product influence the share of breached contracts. Corruption and transparency have positive impact on the share, and the size of the regional economy has negative impact.

**Data set**

We now turn to the characteristics of the database. The data was downloaded from the site (http://rnp.fas.gov.ru/) in July 15, 2011, respectively, it contains the data since July 15, 2009. But we use the data of 2010 year to look on share of breached contracts because the transparency index was measured in 2010.

Also we use available regional statistical information on public procurement from The Federal State Statistical Service (www.gks.ru): numbers of the procurement procedures conducted in one year and the amount of gross regional product. This source is built on self-reporting basis.


What do we mean when say transparent? The amount and accessibility of information in Russian public procurement system is differing among the regions. Though the FL №94 introduced some measures to increase the transparency of information on public procurement the structure of the designated web sites, functions available for users, such as search options, the standard forms for the documents and protocols are not regulated by the law and are decided at the regional level. The law lists only the names of documents (calls for bids, the auction protocols, etc) that must be uploaded to the web site, and the basic information they must contain (starting price of the auction, date of the procedure etc.). Balsevich et al. estimated the index of transparency of information on public procurement.
procurement in the end of 2010 on the basis of the data on the structure of a regional site of public procurement, information, and functions that are available. Our check list includes four groups of parameters that are important from the information transparency perspective: (1) current procurements, (2) completed procurements, (3) search functions, and (4) additional features. They build four indicators that summarize the availability of information and functions for each group of parameters. The resulting index of the information transparency is a weighted sum of the four main indicators described above. Each of the first two indicators (current procurements and completed procurements) give 35% of the resulting index, the indicator of search functions gives 25%, while additional features give 5%. The weights assigned to each indicator reflect our estimation of importance of the information of a certain type for the functioning of the public procurement system. The low weight assigned to the additional features indicator also reflects the fact that the variation in this indicator is rather low (see below). The maximum possible value of resulting index is 100.

To address the question of usability of the information available for the formation of strategic behavior of the potential bidders in the region it is constructed an alternative index of information transparency which accounts for the relative quality of search related to the amount of information available. The second index is represented by the sum of the first two indicators multiplied by the relative measure of search quality.

How is transparency connected with blacklist? A procurer might also appeal to the transparent information on his or her procurement procedures while bringing a case of a breached contract to court. The level of information transparency might affect the number of cases that had to be brought to court by the procurer in two ways. A procurer who runs a nontransparent system might be more corrupt and hence have “better knowledge” of his or her suppliers and less incentives to bring a case to court. A more transparent system might also attract more opportunistic suppliers to a given procedure increasing the chance of breach. On the other hand a transparent system combined with a well functioning courts system might create the incentives to fulfill the contract obligations and keep a “good reputation” for the suppliers. The brief results of the OLS regressions considering the effect of information transparency on the percentage of contracts canceled by court in a given year (information provided by FAS, http://www.fas.gov.ru, and by Russian Bureau of Statistics, http://www.gks.ru) are presented in Table 1. The availability of well structured information on the calls for bids has a significant positive impact on this measure, implying that an “excessive” transparency might attract opportunistic bidders to the public procurement procedures. The availability of unstructured information, on the other hand, has a negative impact on the percentage of breached contracts.
<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>(1) Canceled contracts</th>
<th>(2) Canceled contracts</th>
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<th>(5) Canceled contracts</th>
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<td>-0.00389***</td>
<td>-0.00380***</td>
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<td>Corruption 2010^5</td>
<td>0.0152*</td>
<td>0.0174**</td>
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<tr>
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<td>(0.0169)</td>
<td>(0.0159)</td>
<td>(0.0161)</td>
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<td>(0.0163)</td>
<td>(0.0174)</td>
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<td>Constant</td>
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<td>0.198</td>
<td>0.184</td>
<td>0.200</td>
<td>0.168</td>
<td>0.202</td>
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<td>67</td>
<td>67</td>
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<tr>
<td>R-squared</td>
<td>0.164</td>
<td>0.198</td>
<td>0.184</td>
<td>0.200</td>
<td>0.168</td>
<td>0.202</td>
</tr>
</tbody>
</table>

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Courts decisions and contract characteristics

**Hypothesis 2:** The probability to win the lawsuit with minimum costs depends on the value of measurement costs and on the reason of contract breach. The lower are measurement costs and the clearly is the reason the higher is probability to win.

We considered 181 judicial decisions on cancellations of contracts that were entered in the Blacklist from 14th of April to 15th of July, 2011. We use information related to public procurement procedures and features of contract that are reserve price, contract dates and term of a contract.

To receive another piece of data we analyzed judicial decisions of the cases related to contracts cancellation. Thus we received information about the types of contracts in the form of ownership, the reasons of contracts cancellation, the pecuniary claims of plaintiffs, the results of cases considerations and about the initiator of judicial recourse.

Consequently we obtained some indicators that we used to estimate the probability to win the case with minimal costs. To check of hypothesis we included such indicators as the type of procurement according to the costs of quality measurement and the type of cancellation reasons. As control variables we use the length of the contract in days, the amount of pecuniary claims, the reserve price, the type of procurement procedure, the type of the contract in the form of ownership and the initiator of judicial recourse.

**The probability to win**
The estimation of probability to win the case with minimal costs we use as indicator the result of the case consideration at first instance. We had there different kinds of judicial decisions. The claims could be satisfied, partially satisfied or rejected. In regard to partially satisfaction the rejected claims had basically a pecuniary nature. If the claims were partially satisfied the initiator had the opportunity to appeal a decision. But as we had a goal to estimate the probability to win with minimal costs we didn’t take this fact into account. So the indicator was equal to 1 if the claims satisfied and to 0 if the claims partially satisfied or rejected.

**The measurement costs**
To calculate this indicator we divided all contract subjects into three groups according to the magnitude of quality measurement costs. The first group included procurements the quality of which can be checked on the view of the good or in the process of performing works and rendering of services. This group is named search procurements. The second group included procurements the quality of which can be checked during the application of the good or right after completion of works and rendering of service. This group is named experimental procurements. And the last group included goods, works and services the quality of which can’t be checked or it is too difficult to do this. This group is named credence procurements. Therefore if the contract subject is referred to the search group it was equal 1, if it is referred to the experimental group it was equal 2 and for credible procurements the indicator was equal 3.

**The reason to sue**
We calculated this indicator using the classification of reasons on the ground of their evidence that is how easy the claim can be supported and disputed. We divided all reasons into five groups according to evidence. These are complaints of the quality, untimely deliveries, nonconformance to documents standards, complaints of the delivery volume and absence of the delivery. Subject to the group the indicator took on a value from 1 to 5 respectively. The most evident reason is absence of the delivery.
Complains of the delivery volume is less evident because an additional inspection is needed to check how considerable the breach of the contract was. Nonconformance to documents standards is even less evident because it is not only needed the check but sometimes it is difficult to prove. The same is untimely deliveries. Complaints of the quality are the least evident because there is no objective test of quality and if the principal deals with the experimental or credible procurement it can be too difficult to check the quality.

**The length of the contract**
This indicator was calculated in terms of days under information about contract date and term of a contract. The minimal length is 0 days and the maximal is 950 days.

**The amount of pecuniary claims**
The amount of pecuniary claims we use as a control variable. To calculate it we separated all possible amounts of pecuniary claims in five intervals. The indicator took on a value from 0 to 5 subject to the interval that included the respective amount of pecuniary claims:
- 0 – from 0 to 5000 rub.
- 1 – from 5000 to 50000 rub.
- 2 – from 50000 to 100000 rub.
- 3 – from 100000 to 500000 rub.
- 4 – from 500000 to 1000000 rub.
- 5 – above 1000000 rub.

The minimal value of the amount is 0 rub and the maximal is 302878493,6 rub. The standard deviation is 23403084,54.

**The reserve price**
The reserve price indicator is numeral too. Value distribution of prices was separated in four intervals. As the threshold values we used the median, the first quartile and the third quartile. The indicator took on a value from 1 to 4 subject to the interval that included the respective value of price.

The minimal value of the price is 3081.55 rub and the maximal is 700000070 rub. The standard deviation is 58115065,26.

**The type of procurement procedure**
We encoded this indicator so each type of procedures related to the number from 1 to 5:
- 1 – quoted price request
- 2 – auction
- 3 – e-auction
- 4 – tenders
- 5 – single procurer

**The type of the contract in the form of ownership**
In the form of ownership the procurement can be municipal, regional or federal. To encode this indicator we assigned a value from 1 to 3 to each type respectively.

**The initiator of judicial recourse**
This indicator was equal to 0 if the initiator was a procurer and 1 if the initiator was supplier.

To check the hypothesis we tested the statistically significant relationship between the result of case consideration and two indicators that are the type of procurement according to the quality measurement
costs and the type of cancellation reasons. Thus we run Probit-regressions with the result of case consideration as a dependent variable and another two indicators mentioned above as well as control variables being the regressors. The results are presented in table 2.

### Table 2. Quality measurement costs, cancellation reasons and probability of case satisfied

<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>The probability to win</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measurement costs</strong></td>
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<td>(0.0846)</td>
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<td><strong>Reason to sue</strong></td>
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<td>(0.0302)</td>
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<td><strong>Length of contract</strong></td>
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<td>(0.000263)</td>
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<td><strong>Pecuniary claims</strong></td>
<td>-0.0976***</td>
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<tr>
<td></td>
<td>(0.0256)</td>
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<td>Procedure</td>
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<td>(0.0512)</td>
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<tr>
<td>Type of contract</td>
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<td>Initiator</td>
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<td></td>
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<td>Observations</td>
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<tr>
<td>Pseudo R-squared</td>
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</table>

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

We found the statistically significant relationship between the result of case consideration and the type of procurement. The same relationship was between the result of case consideration and the type of cancellation reasons. So the hypotheses were not rejected.

Thus we concluded that the more quality measurement costs of procurement the less probability of the case satisfied with minimal costs. If it is rather difficult to measure the quality of procurement the quality measurement costs can exceed the benefits after contract cancellation because much information is needed not only to check the quality but to prove it in court. For example some suppliers had to involve the third party for estimation the result of the works. Indeed there were some types of procurements when the quality couldn’t be checked at all that there were no objective parameters of the quality. So the contract is characterized as incomplete. This idea was described by Posner (1986), Tirole (1999) and Battigalli and Maggi (2002). They consider that parties sometimes don’t write some details in the contract because the costs of writing them can exceed the benefits of being writing for example because of low probability of unfavorable outcome.

This relationship is connected with the influence of the cancellation reason on the probability of the case satisfied. By results of the regression analysis the more evidence reason of cancellation the more
probability of case satisfied. It is easier to win the case if the cancellation reason is not connected with the characteristics of procurement that are its quality or pace of work performance because it is not necessary to prove them and it is too little grounds to dispute the claims. But if the supplier has a complaint of characteristics they needed considerable more efforts, information and time and consequently the means to prove it.

Besides the relationships that we aimed to check we obtained two more statistically significant relationships. The first is the more the amount of pecuniary claims the less the probability of the case satisfied. This result was unexpected because there were not subjective pecuniary claims like reparation of moral damage that can be considerably overestimated. All pecuniary claims that are penalty, debt or interests on debt were calculated with reference to legislation so they can influence the probability of case satisfaction only if the legal system is not sufficiently effective. In addition the information about characteristics and terms of contract that related to it can be unobservable or not verifiable by the third party. So the contract is characterized as incomplete and it is impossible to prove the violation of terms in the court. The same idea was described by Shavell (1984) and Schwartz (1992).

The second relationship is the more the length of the contract the more the probability of the case satisfied. This influence is small but relationship is statistically significant. We explained it by the fact that the contract breach is found in the early stages of the contract performance when the claims are not so considerable yet. As a rule if the contract is violated unfairly it becomes clear in the early stage. There was the reserve price in the preliminary specification of the model. We excluded this indicator from the regression because it was significantly correlated with “Pecuniary claims” and “Length of contract” but not correlated with the dependant variable.

**Conclusion**

The main point of this paper is blacklist institution. We look on factors that influence on the demand on this institution in different Russian regions and analyze the factors that influence the ability to use this institution. We point out and show two relations between outlined factors. First, we argue that corruption, transparency and gross regional product influence the share of breached contracts. Corruption and transparency have positive impact on the share, and the size of the regional economy has negative impact. Second, we show that the probability to win the lawsuit with minimum costs depends on the value of measurement costs and on the reason of contract breach. The lower are measurement costs and the clearly is the reason the higher is probability to win. Additionally we find out that there is an influence of length of contract on probability to win with minimal costs. Our data shows that the probability to win is higher in longer contracts. One of the possible explanation, that the buyer goes to court in the first stage of contract, and it is easier to show that nothing has been done and to cancel the contract in court.

One more interesting outcome is the link between probability to win and the expected amount of financial compensation asked by the plaintiff. The more he wants the lower is probability to win with minimal costs. One of the possible explanations the more plaintiff wants the higher is the probability that defendant will disagree with court’s decision. This brings us to the question about efficiency of court system in Russia.
References


Appendix

Picture 1. Six indicators of the quality of the institutional environment in Russia

![Graph showing six indicators of institutional environment over time]

Table 1. Statistics on tenders and problem situations

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<tbody>
<tr>
<td>Number of all tenders</td>
<td>9338807</td>
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<td>11717996</td>
<td>5110787</td>
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<tr>
<td>Number of signed contracts</td>
<td>9320410</td>
<td>10851866</td>
<td>11684517</td>
<td>5086651</td>
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<td>Number of additional agreements to signed contracts</td>
<td>97346</td>
<td>102163</td>
<td>20419</td>
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<tr>
<td>Number of canceled contracts, including:</td>
<td>11793</td>
<td>25963</td>
<td>29880</td>
<td>9976</td>
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<tr>
<td>Mutual Agreement</td>
<td>11644</td>
<td>25741</td>
<td>29425</td>
<td>9735</td>
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<tr>
<td>Court decision</td>
<td>149</td>
<td>222</td>
<td>455</td>
<td>241</td>
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<tr>
<td>Number of invalid tenders, including:</td>
<td>1164</td>
<td>1611</td>
<td>1291</td>
<td>722</td>
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<tr>
<td>Court decision</td>
<td>125</td>
<td>72</td>
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<td>-</td>
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<tr>
<td>Decision of the control authority</td>
<td>1039</td>
<td>1539</td>
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</tbody>
</table>

6 The picture is made based on the site of the World Bank (http://www.worldbank.org/wbi/governance/).
7 The table is made based on the information from the site of the Federal Statistics Agency (www.gks.ru/metod/torg.html).