



*Three views on
modernisation and
the rule of law in
Russia*



*Christopher Granville,
Philip Hanson and
Alena Ledeneva*

Edited by Katinka Barysch



CENTRE FOR EUROPEAN REFORM

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1 Introduction

by Katinka Barysch

In December 2011, tens of thousands of Russians took to the streets to protest against the Russian government. For Vladimir Putin, who plans to become president again in March 2012, this mainly middle-class revolt is deeply worrying. The demonstrators complained about the rigging of the December 2011 parliamentary election. But their deeper discontent is with a political and economic system that can no longer ensure growing incomes for workers nor opportunities for entrepreneurs.

In the four years that he was president, Dmitry Medvedev regularly warned that unless Russia modernised its economy, clamped down on ubiquitous corruption and strengthened the rule of law, the country's future would be dire. Yet very little has happened.

We have asked three eminent experts on Russia why reform is so difficult and what, if anything, has been achieved so far.

Philip Hanson sets the scene by looking at the overarching theme of the Medvedev presidency and the biggest challenge for the decade ahead: the modernisation of the Russian economy. Rather than disentangling the different notions of modernisation employed by the Putin and Medvedev camps, Hanson starts with a simple definition: modernisation means getting Russia onto a growth path that allows it to converge with the richer countries of the West. Such convergence would help the leadership to achieve its two prime objectives, namely maintaining stability at home and great power status internationally. However, it is not happening. Russia's boom years are over, while capital and talented people are leaving the country in droves.

The kind of top-down, targeted interventions that Putin calls modernisation will not alter this state of affairs. Hanson explains that in the absence of easy money from abroad, rising oil prices and strong European demand, the only source of economic growth is higher productivity. However, productivity growth is constrained by a shoddy investment climate, a dire science and research base, insufficient competition and ill-functioning financial markets. Of particular importance is the judicial system. Unless Russian companies and investors enjoy secure property rights and decent returns on their money, investment will remain too low to bring Russia's economy forward.

Alena Ledeneva agrees that profound reform is necessary but she warns that in Russia's complex and opaque political and economic system, this will be far from straightforward. On the surface, Russia's political system is a tightly managed 'vertical of power' while its economy combines large chunks of market economy with elements of state control. However, informal systems of power and governance are at least as important to understanding how Russia really works. Ledeneva calls the interaction between formal hierarchies and informal networks held together by clientelism, kickbacks and corruption *sistema* (the system).

Sistema has many absurd traits and it might ultimately be self-destructive. This informal system keeps Russian society together and allows the leadership to mobilise the Russian elites for their purposes, including top-down modernisation projects. But by doing so, *sistema* creates the wrong incentives (short-term rent-seeking rather than sustainable investment, slavish loyalty not innovation), locks people into the system (corrupt officials are forever compromised) and hollows out the very principles that Russia needs for long-term prosperity, such as the rule of law and accountability.

Sistema cannot simply be 'reformed'. Insiders either lie to themselves about what they are doing or they refuse to speak out about it because they fear losing positions and perks. Outsiders by definition

have little power to alter the system. Unless Russia's leaders become fully aware of how *sistema* works, spell it out and start modifying their own behaviour, Russian modernisation cannot succeed.

Christopher Granville shows in his contribution that enlightened top-down reform is possible in Russia, namely in the narrow but hugely important area of commercial jurisdiction. The destruction of the Yukos oil company on tax fraud charges or the shareholder battle over VimpelCom, that almost forced Norway's Telenor out of the Russian telecoms market, have done terrible damage to the Russian investment climate. However, since Anton Ivanov took over as chairman of Russia's highest commercial court, the Supreme *Arbitrazh* Court (SAC), in 2005, the risks that companies face in the court systems have gone down.

Ivanov's SAC has had a threefold positive impact on the judicial system, and the business environment more generally. First, through its clever selection of cases for review, the SAC has put lower courts on their guard: companies that are struggling with corrupt bureaucrats or predatory business partners now have ultimate recourse to a court with a track record of upholding property rights. Second, the SAC has successfully established the right to set precedent through its verdicts and general statements. Hence, the SAC is not only binding lower courts but it is clarifying and expanding commercial law – a hugely important development in a country with many badly written laws and incompetent and/or corrupt judges. Third, Ivanov is now making proposals for general judicial reforms, in particular the process through which judges are appointed and removed. Granville warns, however, that Ivanov's judicial reforms will only succeed in a more pluralistic political environment.

2 Why is Russian modernisation so difficult? *by Philip Hanson*

Russia's political leaders have spoken at length about their determination to 'modernise' Russia. They do not all mean the same thing by this but they do all regard an acceleration of technological change as a key policy target. Adopting a minimalist view of the meaning of modernisation, I will review the main obstacles to achieving it, and consider where reform of the judicial system fits in. I shall add some comments on Britain's role in the non-standard management of Russian wealth.

Catching up is the overarching goal

The Russian leadership's most compelling political goals are maintaining the country's domestic stability and its international standing as a major power. The achievement of these goals would be facilitated if the Russian economy could get on to a higher growth path – one that would see it converging rapidly with the income levels of the advanced countries. Faster growth would also allay the main concerns of Russian businesses and arrest the outflow of capital, both financial and human.

The minimalist definition of modernisation, then, is a clear and sustainable acceleration of Russian economic growth. This might or might not entail diversification of the economy away from oil and gas.¹

¹ *For an argument in favour of Russia sticking with its comparative advantage in natural resources see Clifford Gaddy and Barry Ickes, 'Russia after the global financial crisis', Eurasian Geography and Economics, 51:3, 2010.*

However, rapid economic convergence is not happening at present. The situation after the global economic and financial crisis is quite different from the situation before it. Between 1998 and 2008, Russian GDP grew at an annual average rate of about 7 per cent; real personal incomes grew even faster as Russia's terms of trade improved (the prices of its exports rose faster than those of its imports). The confidence of the Putin leadership strengthened in step with the economy; its domestic popularity seemed assured. However, after a deep recession in 2009, Russian GDP growth recovered to only 4 per cent in 2010 and 3.9 per cent year-on-year in the first half of 2011. Now the Russian Ministry of Economic Development (MinEkon) concurs with the IMF and other authoritative forecasters in projecting Russia's medium-term growth at around 4 per cent per annum.

² *Labour productivity is calculated as \$/GDP per capita at purchasing power parity (Russia \$30,500, Germany \$69,900) divided by employment. Data are from the IMF World Economic Outlook database of April 2011, except for Russian employment data, which are from Rosstat.*

³ *Since Russia's workforce is declining, any GDP growth leads to faster growth of GDP per worker, or higher labour productivity. A mature economy like Germany cannot achieve GDP growth per worker at 5 per cent a year or more over any sustained period. So the productivity gap between Russia and the richer countries would narrow.*

Such annual growth rates are perfectly respectable. But they are disappointing after the long boom that Russia had enjoyed. Before the crisis, Russia seemed to be on course for 'catching up and overtaking', to use the old Soviet phrases. Catching up is still in prospect but – absent a galvanisation of Russia's economic performance or an implosion of the advanced economies – only in the very long run. Overall, from Moscow and Tyumen to Tyva and Ingushetia, Russia still lags far behind North-West Europe and North America on most indicators that matter for growth.

Given that the Russian labour force is shrinking and capital investment rates are low (see more below), the only source for Russian growth is higher productivity. In 2009 Russia's labour productivity was about 3/7 of that of Germany.² A sustainable growth rate well above 5 per cent a year would make visible inroads into that gap and would, I suggest, largely satisfy the aspirations of the present leadership.³

Such growth would also assuage the worries of many Russian business people. Before the crisis, in 2006-07, Russia had just begun to enjoy for the first time a net inflow of private capital. That this inflow reverted to an outflow during the 2008-09 crisis was not surprising. But the net outflow continued in 2010, to the tune of \$34 billion, and accelerated in the first half of 2011, with \$31.2 billion leaving the country in just six months, according to the Russian central bank.

A new class of pessimists

The capital outflow is accompanied by an exodus of people, plus many more allegedly 'sitting on their suitcases' in readiness to depart. The migration data do not show this exodus, but they are not trusted. Rightly or wrongly, many believe the Russian business class – and perhaps particularly the owners, co-owners and potential owners of small and medium-sized firms – are deeply discontented.

The favourite explanation in the Russian liberal media for this (alleged) state of affairs is the poor institutional environment for business.⁴ But it is not clear that the famously uneven playing field has become any more uneven since the days of a net inflow of private capital in 2006-07. The following conjecture is more plausible: the reduced prospects for the Russian economy, on top of a lack of clear improvement in the institutional environment, have produced a new class of pessimists.

⁴ *Most of those leaving the country do not declare themselves to be emigrating nor relinquish residence in Russia, so the true numbers of those emigrating are not known. Moreover, there do not appear to be surveys among those who do officially emigrate, asking them for their reasons for doing so.*

The slowdown explained

Russian growth is slower now than before the crisis because a number of circumstances, both domestic and external, have changed.

Until recently, Russia's labour force had been rising despite a fall in the total population. Now, however, the labour force is in decline,

⁵ *Ministry of Finance reporting of a MinEkon estimate.*

and MinEkon projects employment to decrease to 64.6 million in 2020, from 67.7 million today.⁵ The precipitous fall in the number of

young labour-force entrants also has indirect effects. It limits labour mobility and the rate at which the workforce as a whole gains new skills, so it has a negative effect on productivity growth. Moreover, during the boom years (1999-2008), the shape of the Russian economy changed quite quickly and the accompanying shift of labour and capital from less to more productive lines of activity resulted in significant productivity gains. Such productivity gains, though still there, are probably getting smaller.

External circumstances are not helpful, either. The EU economy, which accounts for about half of Russian exports, is unlikely to be thriving for some time. Worldwide de-leveraging continues and makes a return to the mid-2000s surge of foreign lending to Russian companies unlikely for quite a while.

Another important source of Russia's pre-crisis boom was a continuously rising oil price. While the oil price is still high, it is not widely expected to go on rising strongly in coming years.

Russia needs new sources of growth

In this situation, a search for new sources of dynamism leads, quite reasonably, to policies that would facilitate faster introduction of new (for Russia) products and processes. This is why the leadership is putting so much emphasis on the 'modernisation' of the economy.

The Medvedev and Putin versions of modernisation differ. Medvedev's idea seems to be broader, counting social liberalisation as part of the process. Putin's treatment of the subject is more narrowly focussed on upgrading industrial technology. Both, however, rely heavily on top-down, state-led innovation – which is problematic, given Russia's ineffective and corrupt state apparatus. Another difficulty is that the leaders and their senior officials have

tended to over-emphasise the importance of Russia somehow moving to the leading edge of world technology, while they have under-emphasised the role of faster absorption of foreign technology.

Middle-income economies in the catching-up process usually rely on the import of advanced machinery and processes from richer, more sophisticated economies, including inward foreign direct investment by leading international companies, patented technologies, and education and training provided from abroad. The middle-income countries' own education, training and research and development (R&D) usually complement this assimilation from abroad; they do not generate much that is globally new. Russia's history of independent research and innovation in Soviet times, with a large scientific and engineering establishment of its own, fosters the illusion now that the country could go it alone. In fact, even when the USSR was achieving strategic parity in the early 1970s, its science and technology were heavily dependent on imports from abroad, and narrowly focussed on the military sphere.

Today, the weakened state of Russian science and education is a handicap for any economic upgrading. In the 2010 global university rankings from QS (an educational consultancy), only one Russian university (Moscow State) makes it into the top 200, while China has nine and Korea four. In an open letter to the Russian president and prime minister (published in the Russian newspaper *Vedomosti* on October 2nd 2009), a distinguished group of expatriate Russian scientists described the current state of fundamental science in Russia as "catastrophic".

Russia's current industrial structure does not help: the largest industrial sectors, oil, gas and metals, do not have a large appetite for R&D. Instead, the state finances and carries out most R&D; this is reasonable for fundamental science but not for applied research and development. Even though much of Russia's technology will continue to come from abroad, Russia needs a

smaller and more efficient array of advanced training and research establishments to support the spread, development and deployment of new technologies.

A problematic business environment

Russian liberals usually point to the weakness of Russian economic institutions as the fundamental barrier to successful modernisation. While institutions are not the only problem, they do matter. Russia's institutions are not, under present circumstances, conducive to faster growth. For a start, they do not encourage private investment. This matters because much, if not most, technological progress is 'embodied' in the investment in new machinery and equipment.

For most of the post-communist period, Russian firms and households have been saving more than they have been investing in Russia. This is reflected in a modest ratio of fixed investment to GDP (20.5 per cent in 2010) and in the net outflow of private capital mentioned above.

The underlying problem seems to be that investors cannot be sure that they will obtain decent returns on their investments in Russia. One problem is that the protection of property rights is weak. Russia's large companies are owned through holding companies registered offshore, usually in tax havens. Businesses all around the

⁶ Philip Hanson, 'Russia's inward and outward investment: Insights into the economy', *Eurasian Geography and Economics*, 51: 5, October 2010.

world use tax havens to 'optimise' their tax bills. But the Russian owners of businesses have invested in tax havens to an unusually large extent, and that is symptomatic of the lack of trust in property rights at home.⁶

Country rankings on governance and the business environment show up further weaknesses in the Russian investment climate. In the World Bank's governance ratings for 2009, Russia came 189th out of 213 countries on 'rule of law' and 202nd on 'control of corruption'. Similarly, in the World Bank's ranking of the 'ease of

doing business', Russia stood at 120th place out of the 183 countries assessed in 2011. These rankings are particularly poor in view of the fact that Russia is a middle-income country. Of the class of 'upper-middle-income' countries to which Russia belongs, it was 40th out of 49.

Markets work poorly

One of the consequences of the poor institutional and legal environment is that markets for goods, services and capital work less effectively in Russia than they should. In many sectors, powerful incumbent firms have strong informal links with municipal, regional or national officials. They deploy those links to block newcomers from entering the market or to hamper rivals that have managed to set up shop. The OECD product market regulation measures for 2008 show Russian goods and services markets to be substantially more circumscribed by state controls, barriers to trade and investment, and obstacles to entrepreneurship than the OECD average, and more so than even a poorly-functioning OECD economy such as Greece.

The Russian capital market looks at first sight reasonably well developed. Market capitalisation is respectable for a middle-income country. However, the stock market is very illiquid. The big companies that dominate it (both state-controlled and private) are, as described above, usually controlled through offshore holding companies. So the 'free float' of tradeable shares is small. One measure of liquidity is the ratio of market turnover to end-year market capitalisation. On developed stock markets this is typically around 100 per cent or more. For Moscow's main market, the MICEX, it was only 43 per cent in 2010. For comparison, the ratio for the Istanbul market was 127 per cent.⁷ Istanbul has been upgraded by FTSE from 'secondary emerging market' status to 'advanced emerging market' status in June 2011, while Moscow's MICEX remains in the former category.

⁷ Data from the Federation of World Exchanges.

The low ratio of turnover to capitalisation is not a matter merely of esoteric financial arithmetic. It means that Russia lacks a functioning market for corporate control: that is, a market in which by more or less open competition companies can be purchased by those who expect to be able to extract more value from the assets involved. Instead, Russia has its own version of corporate raiding (*reiderstvo*). It characteristically involves takeovers by illegal means, often with law-enforcement or other officials complicit in the operation. It does not necessarily transfer assets to more efficient owners.

One must not paint too black a picture. There are Russian companies that are internationally competitive and innovative in areas of high technology. Kaspersky Lab (anti-virus software) and Yandex (search engines) are examples. Nevertheless, a large part of the Russian economy is made up of politically well-connected incumbent firms that are protected from effective competition. Many of the owners of these firms keep more of their control (in the form of equity voting rights) and their wealth offshore than they would if Russia's business environment were sounder.

Courts and the business environment

The courts are part of the framework within which business is conducted. It is dangerous to generalise about Russian courts. Foreign-owned firms have been known to win court cases against the Russian tax authorities and against well-connected Russian companies. But powerful Russian tycoons have quite often obtained very strange court decisions to their advantage and to the disadvantage of a rival or partner. Prominent examples reported in the Western media include Hermitage Capital and Telenor. Hermitage Capital, an investment fund, narrowly avoided having subsidiaries stolen from it in a scam operated by senior Russian police officers. Tragically, Hermitage's Russian lawyer, Sergei Magnitsky, who revealed the scam, was arrested and died in custody. The Norwegian telecoms company Telenor nearly lost its \$1.7 billion stake in VimpelCom, a Russian mobile phone provider, to

machinations probably devised by its Russian partner. In both cases compliant Russian courts helped the asset-grabbers involved (although in the case of Telenor, a settlement could be found, as Christopher Granville explains later).

Not only foreign investors experience such difficulties. The Russian state from time to time uses environmental regulation, taxation and natural-resource licensing to exert administrative pressure and wrest control over a company away from its previous owner: prominent examples are Russneft from Mikhail Gutseriev; and Sakhalin 2 from Shell, Mitsui and Mitsubishi. Russian tycoons are likely to use flexible courts for the same purpose. Such behaviour is best seen not as a purely judicial matter but as part of the more general operation of 'the system', as described by Alena Ledeneva.

What needs to be done

The Russian economy is growing more slowly than the economies of several other large, middle-income countries, and more slowly than it was before the financial crisis. The political leadership wants to see growth accelerate and is relying on 'modernisation' to achieve that goal. The slowdown is due partly to factors beyond policy-makers' control, namely demographics and a changing international environment. Nevertheless, a liberalised, reliable business environment would greatly contribute to a return to faster growth. The reforms needed to achieve this are complex and involve improved education and R&D environments, better functioning markets, stronger protection of property rights, a clear rule of law and an effective judiciary. Faster growth will not be achieved through the targeted, top-down interventions foreseen in current modernisation plans.

Britain and the Russian system

A review of the characteristics of the Russian business world can be a recipe for smug self-congratulation on the part of outsiders. However, two British connections might give us pause for thought.

One is the considerable overlap between Moscow's favourite tax havens and British interests. Bermuda, the British Virgin Islands, the Cayman Islands and Gibraltar are all British dependencies. Jersey and the Isle of Man are British Crown Dependencies. Even Cyprus was under British control not so very long ago. The overlap is, if nothing else, a touch embarrassing.

The other is the Russian companies' preference for listing on the London Stock Exchange (LSE). It is desirable, other things being equal, for the City of London to benefit from Russian business, and for Russian companies to tap foreign capital markets. But other things are not always equal. Are listing requirements as demanding as they should be? Is it the case, as is sometimes claimed, that London is preferred to New York because listing requirements in New York are tougher? And are there perhaps occasions, such as the initial public offering by the state oil company Rosneft after it had acquired most of the assets of Yukos (the firm of incarcerated former tycoon Mikhail Khodorkosvky), when considerations beyond the immediate financial benefits to the City should have been given more weight? In other words, the prospects of gains for City businesses may have outweighed due concern for a longer-run good: the LSE's reputation as an exchange open only to firms with good governance and of good repute.

The debate over the listing of Polyus, Russia's largest gold producer, on the LSE exemplifies the problem. In 2011 Polyus sought a 'primary' listing, which would have added it to the FTSE 100 and made its shares part of a standard investment for many UK institutions, such as pension funds and insurance companies. A premium listing normally requires that 25 per cent of a stock is freely traded. Most of Polyus is held by two Russian investors and the company was seeking a premium listing subject to a waiver on the free float requirement, allowing it to be quoted with only 13 per cent of its shares freely

traded. As Karin Litvack of F&C Investments wrote, the FTSE 100 index has "...progressively admitted a disproportionate share of extractive companies based in jurisdictions where rule of law is often called into question" (letter to the *Financial Times*, October 20th 2011).

Britain, along with other Western countries, is not well placed to preach to Moscow about the business environment when some of its own institutions are complicit in the dubious Russian practices that we deplore.

3 *Sistema* - Russia's informal system of power by Alena Ledeneva

Informality is the key to how politics, the economy and society function in Russia. If we want to understand how power works, we have to delve behind the Kremlin's formal facade and take into account informal networks, clientelism, kickbacks, complex rules and subtle signals. The term *sistema* (the system) refers to opaque ways in which informal networks interact with formal hierarchies.

Sistema cannot simply be 'reformed' in the traditional sense of the word. First, *sistema* is one of Russia's open secrets. Most Russians, and especially the elites, know what it is and how it works, but they would rather not spell it out. If they talked about it openly, the system's absurdity would become apparent. But the elites do not want to challenge *sistema* since this could get them expelled from their formal positions, from informal networks, or even from the country. Yet as long as Russia's elites do not challenge how the country is governed, meaningful change is impossible. Second, while *sistema* is in many ways absurd, detrimental for long-term development and probably ultimately self-destructive, it is also the glue that keeps Russia's economy and society together. If *sistema* unravelled, the consequences would be hard to manage.

Modernisation in Russia cannot succeed as long as this system of informal power and governance remains untouched. Russian leaders talk about changing Russia from the top down, without however addressing the informal rules and constraints that govern their own behaviour and that of political, bureaucratic and business elites.

Informal power and its instruments

Instruments of informal governance are not new, nor do they

⁸ Thomas Christiansen and Christine Neubold, 'International handbook on informal governance', Edward Elgar, 2012.

⁹ The Constitution Unit at University College London and Professor Robert Hazell, 'Inside Number 10: How the coalition really works', *Political Insight*, September 2011.

¹⁰ Thomas Christiansen and Simona Piatoni, 'Informal governance in the European Union', Edward Elgar, 2003.

only exist in Russia.⁸ For example, a recent study of Britain's formal and informal cabinet machinery throws light on how the British government really works.⁹ An older study warns of the potential dangers of informal governance inside the European Union.¹⁰ Not all informal links amount to informal governance, however. For example, Prime Minister David Cameron's links to the scandal-ridden Murdoch press bear little resemblance to the systematic links between political leaders and the media in Russia. The existence of informal practices in a society does not mean that there is a hidden system. It is only when such patterns of behaviour are repeatedly or predictably used that they transform into a system.

In Russia over the centuries, informal rules and practices have often been at least as important to understanding the workings of power and commerce as formal constitutions and laws. Tsarist Russia had its own *sistema* and so did the Soviet Union. A different *sistema* has evolved during the rule of Vladimir Putin.

Putin's *sistema*

On the surface, Putin's Russia is governed through a 'vertical of power', a hierarchy in which decisions are passed from the top down, from the centre to the regions, and from the government through the economy. But Putin's *sistema* also contains networks, controls and constraints that undermine this vertical and skew its policies. *Sistema* consists of the mix of formal governance (which is the result of official hierarchies and policies) and informal networks and influences.

Some observers have described Putin's governance model as neo-Soviet, because of its reliance on strong leadership, economic control, superpower ambitions and confrontational foreign policy. It has also been said to reproduce the 'stability of cadres' (an enduring and closed ruling elite) once associated with Brezhnev's period of late socialism. Top officials and insiders are shuffled around, but few ever get sacked or seriously demoted. Putin does not betray his own people – unless they break informal agreements and go against *sistema*.

Putin's *sistema* has some elements of the 'administrative-command' style of governance of late socialism (these were: state property, central planning, bureaucratisation, resource allocation on the basis of ideology and the mobilisation of cadres, or elites, through a defined command structure). But there are also significant differences: the party line has given way to private interests, state property to privatised assets, economic planning to the constraints of global markets, an economy of favours to pyramids of kickbacks, and command methods to instruments of informal governance.

Because *sistema* is complex, subtle, and ambivalent, most Russians find it difficult to spell out what they mean by it. When prominent journalists such as Yulia Latynina and Andrei Loshak write about Putin's *sistema*, insiders smile at its paradoxes while outsiders are shocked by its absurdity or simply doubt its existence. Let us consider an example.

IKEA's experience with *sistema*

Andrei Loshak uses the story of the Swedish furniture giant IKEA to illustrate the corrupt and counter-productive nature of the system: "[When it opened its first branches], the company announced that even in Russia it would be adhering to its clearly-formulated Swedish rules, based on the Protestant work ethic [which mandated that no bribes would be given]. As a result, officials in Khimki [a small town near Moscow] turned off the electricity just before

IKEA's first Moscow store was to open. There was no practical reason for this. They just wanted to 'give them a hard time' for their excessively strict principles. By the time IKEA opened in St Petersburg, the Swedes already knew that they had to have their own generator in each of their Russian stores – just in case. A wise decision, as subsequently emerged.”¹¹

¹¹ Andrei Loshak, 'Kafka's castle is collapsing', *openDemocracy*, March 19th 2010.

The company has opened 230 stores all over the world, but was unable to overcome what Loshak calls the 'implacable cupidity' of the officials in the Volga city of Samara: "The last complaint [of the Samara officials] was that the building was insufficiently hurricane-proofed. The Swedes were unable to obtain any information about destructive tornados wreaking havoc on the left bank of the Volga and took umbrage. IKEA's legendary founder Ingvar Kamprad announced that investment in Russia would be scaled down. But local officials were unlikely to be fazed by such trifles. Their actions are, after all, not dictated by narrow personal interest. They are supporting the normal functioning of an irrational system."

The question for foreign investors in Russia is whether it is possible to work within the system without getting involved in reprehensible practices. Loshak suggests that it is near impossible to work honestly in a corrupt environment. In other words: foreign investors cannot import their values if these contradict the values embedded in *sistema*.

IKEA had seen itself as a kind of Sir Lancelot intent on beheading the dragon of Russian corruption. But since corruption is an integral part of the system, the dragon immediately grows yet another head. In IKEA's case, a subsequent investigation revealed that the Russian employee responsible for procuring the generators was receiving kickbacks from the leasing company. These kickbacks considerably increased the costs of IKEA's corruption-avoidance strategy – while also feeding the dragon.

Loshak found that the Russian judiciary appears to be operating in a similarly absurd fashion: when IKEA tore up its agreement with the corrupt leasing firm, a Russian court fined it €5 million for breach of contract. "We had come up against something way outside what we usually encounter," said an IKEA source. The Swedes, just like the surveyor K in Kafka's 'The castle', tried to use the powers of reason to overcome the absurd – a fruitless attempt.

Paradoxes and traps of *sistema*

Loshak distils the absurd logic of *sistema* in the sentence "We were born to make Kafka come true" and speaks of an 'oxymoron culture' in which ideas such as 'conservative modernisation', 'sovereign democracy' and 'Parliament is not the place for discussions' disorient and brainwash the public. Latynina agrees, arguing that *sistema* provides absurd incentives.¹² Basic economic principles are turned on their heads: good deeds and value creation are punished while the extraction of kickbacks and rent-seeking behaviour are rewarded. *Sistema* does not punish wrongdoing; instead it defends its supporters and maximises the power of officials in charge of the distribution of funds. In this "through-the-looking-glass" land, writes Latynina, the very term *sistema*, which originally stood for a well-organised and co-ordinated structure, has come to mean its opposite. Among Russia's systemic paradoxes, Lilia Shevtsova, an analyst at Carnegie Moscow identifies "the failure of success, the uncertainty of certainty, the instability of stability and the impotence of omnipotence".¹³ She argues that the economy functions in a dysfunctional way: the economic growth and stability of Putin's Russia is detrimental to the country's development in the long term.¹³

¹² Yulia Latynina, 'Swarm or the antibaker – How modern Russia actually works', *3rdway.org – Third Way Liberal Discussion Forum*, March 26th 2010, translated by Viktor Tanatov from the Russian version first published in *Novaya Gazeta*.

¹³ Lilia Shevtsova and Andrew Wood, 'Change or decay: Russia's dilemma and the West's response', *Carnegie Endowment for International Peace*, 2011.

In my view, to describe the workings of *sistema* as absurd and self-defeating is at best a partial truth. Even if it is hostile,

anonymous, unpredictable and seemingly irrational, *sistema* also serves to glue society together, to allocate resources and to mobilise people; it contributes to both stability and change; and it ensures its own reproduction.

Russia's present-day *sistema* encourages the Russian people to work, but in an ambivalent, even paradoxical, way. Its system of incentives prioritises short-term profit at the expense of long-term sustainability; loyalty at the expense of professionalism; safety and collective responsibility at the expense of corporate leadership; and innovative strategies to circumvent the constraints of *sistema* at the expense of productive innovation. Russia's self-made businessmen often say that they have achieved their success despite *sistema*, whereas businessmen that are *sistema* insiders tend to be silent, or they deny that their success owes much to close links with influential politicians.

The impact of informality is not exclusively negative. One cliché about corruption in Russia is that the economy would not be able to work without it: anti-corruption policies cannot be effective until and unless Russia first addresses the problems associated with ineffective institutions, especially the judiciary.

In the short run, tools of informal governance (see box) can help leaders to pursue their policy objectives. Such tools help them to exert control over the media, bureaucracy and judiciary as well as parts of the economy. For example, companies in Russia know that the political leadership expects them to show 'corporate responsibility' through supporting political, social, youth, environmental and charity programmes. The leadership also uses informal leverage and networks to promote its modernisation agenda. So companies feel compelled, if not privileged, to sign up to Kremlin-sponsored projects such as the Skolkovo innovation city, even if they do not believe in their viability.

Tools of informal governance

I distinguish four types of instruments of informal governance: informal agendas, informal signals, informal affiliations and informal sanctions. Take the example of Russian television. Employees of all major TV stations have informal affiliations with the Kremlin. Control is exercised through informal signals, or even directives, such as black lists of individuals who should not be allowed to appear on TV, or white lists of people who should not be criticised. Informal agendas are revealed when TV stations routinely omit certain subjects or ignore certain individuals perceived as disloyal. For example, after Alexey Kudrin resigned as finance minister in September 2011, his face never appeared on Russia's official broadcasters; and records of his angry exchanges with President Medvedev were cut down to Kudrin's retort that stepping down would be his own decision.

Informal sanctions consist of diverting advertising away from disloyal TV channels, or by hinting to private banks which media organisations should have access to loans and which should not. Instruments of informal governance tend to be subtle and do not violate the law as such. One cannot pin down a bank or a private entrepreneur for not giving a loan or placing an advertisement on this or that channel, for the formalities are duly preserved.

In the long run, however, the informal tactics for mobilising elites and allocating resources to insider networks undermine the fundamental principles of the rule of law, the separation of powers and the security of property rights. Ultimately, they reduce Russia's chances of achieving the strategic goals of modernisation. I call this the 'modernisation trap of informality': one cannot use the potential of informal networks without triggering their negative long-term consequences. Informal networks enable Russia's leaders to mobilise people and resources for their modernisation projects. In the process, they create vested interests and lock politicians, bureaucrats and

businessmen into informal bargains and pledges of loyalty that then impede change and modernisation.

The intricacies of informal governance are hard to monitor and measure. Insiders often do not fully recognise these intricacies themselves – or they have built up a capacity to deny to themselves what they are doing. A recent survey of 500 top managers of a large state-owned company in Russia illustrates this point. When asked to assess their own leadership style in running their departments, the majority of the managers described themselves as either “visionary” or “democratic”. Yet 90 per cent of them said that the day-to-day leadership style prevalent in their company was “coercive”. This massive gap between people’s self-perception and their assessment of the governance system they operate under shows that *sistema* insiders somehow have to deal with its paradoxes and double standards, be it through self-deception, denial or cynicism.

Moreover, *sistema* leaves its insiders compromised and vulnerable – which makes it all the more difficult for them to speak out against the system. Widespread corruption, for example, helps to hold *sistema* together. Those involved in corruption are compromised, their property rights are insecure, and they are therefore bound into the system. Those people who do not want to play by the rules of the game face a choice: they can become passive members of society

¹⁴ Olga Kryshтанovskaya, ‘Anatomii rossiskoi elity’, *Zakharov*, 2005. without any prospects for advancement or enrichment, or they can challenge *sistema* and embark on the thorny path of dissidents.¹⁴

Exit and voice

When people fall out with *sistema*, they often, as outsiders, find it easier to see its contours and speak out against it. But not every criticism of *sistema* practices means that an insider becomes an outsider. Take the examples of Mikhail Prokhorov and Alexey Kudrin.

As Russia’s third-richest businessman and owner of the New Jersey Nets, Prokhorov had been known more for his lavish lifestyle than his political ambitions until, in June 2011, he became leader of the ‘Right Cause’ party. Right Cause has evolved out of a number of small but unsuccessful liberal parties, and is now widely assumed to be a ‘pocket opposition’ party used by the Kremlin to capture the urban liberal vote.

In 2011, the Kremlin decided the party needed a more effective leader and Prokhorov took over. However, after a brief and failed attempt to add his own candidates to Right Cause’s list, Prokhorov was expelled from the party in September 2011.

Prokhorov’s story demonstrates the double standards inherent in *sistema*. He did not mind playing by *sistema*’s informal political rules that placed him in the position of party leader. When he was expelled, however, he accused Vladislav Surkov, the Kremlin’s then chief of political operations, of being a “puppet master” for having engineered his dismissal and stifling ‘real’ political opposition. Prokhorov seemingly preferred a loud exit from *sistema* to compliance with its rules on loyalty.¹⁵

It is also possible to express discontent within the confines of *sistema*, as illustrated by Kudrin’s departure after eleven years as Russia’s finance minister. After Kudrin had openly disagreed with President Medvedev over budget spending, he was asked to resign. But Kudrin used his resignation to show loyalty to Putin so his options have remained open.

The fact that some prominent figures are willing to speak out against *sistema* could be an indicator of change within the political elite. However, speaking out is generally equated with going against *sistema*, which usually

¹⁵ In December 2011, after this essay was written, Prokhorov announced that he would run in the March 2012 presidential election. Many observers suspect that Putin backs Prokhorov’s decision, to give the election a veneer of pluralism. The fact that Prokhorov seemingly returned to favour despite his attacks on Surkov could reflect Surkov’s waning fortunes: in December Surkov was removed from his political role to become deputy minister for modernisation.

results in expulsion. Most members of the elite will be reluctant to cut the branch they are sitting on, so they will continue to play by *sistema* rules.

Reform needs to start above, not from above

By keeping *sistema* insiders compromised and under suspended threat of punishment, Russian leaders can shape their decisions and manage power networks. By resorting to informal tools of pressure or blackmail, however, the leaders themselves become compromised, which makes them less likely to question their own leadership style. Russia's current leadership is talking about reforming Russia 'from above' by focusing on changing the behaviour of others (often using informal tools). But it is unrealistic to expect them to reform the 'above' – themselves – first, which would involve leaders reflecting on the informal ways they use to get things done, admitting and changing them.

It is this self-reflection, the need for the elites to transform themselves before they seek to change others, that is the key to Russian modernisation. Previous modernisation attempts in Russia, including the reforms of Peter the Great, liberalisation under Alexander II and Gorbachev's *perestroika*, failed to achieve their long-term objectives. These leaders changed institutions mostly according to imported templates. But they left untouched the informal governance mechanisms, the inner workings of *sistema*. I argue that the reason for that recurrent failure was that the leaders of these reform efforts never became fully aware of the power networks and informal instruments they used to advance their modernisation agendas. In this sense, they acted blind-folded. They made what looked like profound changes, but they could not make these changes sustainable because the new formal institutions and rules did not correspond to the underlying informal norms and customs.

As soon as Peter the Great passed away, and with him his strong personal control over new institutions and key actors, *sistema* made

a full comeback. Russian bureaucrats – now residing in newly built, European-looking St Petersburg, dressed in West European attire and conversing in German and Dutch – returned to the more comfortable practices of profiting from their government jobs, promoting friends and relatives and diverting public funds toward private projects (or private funds to public projects).

It will take an enlightened leader (or group of leaders) – one who is self-aware – to fight *sistema*'s destructive forces while preserving its capacity for innovation, and gradually to replace informal tools with effective alternatives. Russia's modernisation campaign cannot reach its ambitious goals unless the consequences of informal governance are spelled out.

It is tempting to assume that there are obvious reform measures that Russia could undertake to replace *sistema* with a market economy and the rule of law. But *sistema* enables Russian society to cope with its problems while at the same time undermining those reforms. Unless Russia's leaders address this fundamental paradox, there is no obvious way of tackling *sistema* without weakening the social cohesion that enables Russian society to function.

4 Russia's commercial courts: A bright spot *by Christopher Granville*

In his frequent and frank public remarks about Russia's corruption epidemic and poor investment climate, President Dmitry Medvedev almost invariably highlights shortcomings in the country's judicial system. His criticism dwells typically on the inadequate impartiality and integrity of the judiciary, and the reality that defendants and litigants cannot be confident that the courts will hand down verdicts that are of a good legal quality and fundamentally fair. As a former professional lawyer who has participated actively in judicial reform, Medvedev cannot be accused of uttering political commonplaces. Similarly, when he tempers criticism of the courts and judiciary by suggesting that there have been some real improvements in recent years, this should not be taken as mere token balance or self-congratulation.

However, Medvedev has not singled out for public praise the most ambitious and successful judicial reformer in Russia today – his classmate and fellow star student at the Law Faculty of Leningrad (now St Petersburg) State University in the late 1980s, Anton Ivanov.

In 2011, Ivanov completed his first six-year term as chairman of the Supreme Arbitrazh Court (SAC), Russia's highest commercial court, and was reappointed to a second term of office until 2017.

¹⁶ *Arbitrazh is one of the Russian language's many loan words, but its obvious derivation from the Latin 'arbitrate' does not signify that these courts are arbitration tribunals. They are, rather, proper courts of law specifically mandated to deal with commercial cases.*

Under the leadership of Ivanov's SAC, Russia's specialised system of commercial, or *arbitrazh*¹⁶, courts has built up a track record of

upholding the rights of property owners and creditors, righting wrongs in corporate governance and generally supporting the development of a competitive market economy. Although such progress will not be felt directly by Russian citizens, it is of the greatest importance for longer-term business confidence, the investment climate and economic growth.

Businesses increasingly trust commercial courts

Surveys show that businesses have come to regard the *arbitrazh* courts as providing increasingly reliable recourse against the tax authorities in particular. This perception may strike some readers as surprising – particularly in the light of the Yukos affair, in which the *arbitrazh* courts upheld tax claims that resulted in the complete destruction of the shareholders' equity in a company with nearly \$40 billion market value. Since then, however, a large majority of tax disputes (around 80 per cent in 2008, according to statistics collected by the SAC) have been resolved in favour of corporate taxpayers.

¹⁷ *Vedomosti*, February 16th 2011.

In an interview marking the end of his first term as SAC chairman, Ivanov took undisguised pride in the court's achievement in the field of tax law.¹⁷ The SAC, he said, had filled in lacunae and resolved inconsistencies in poorly drafted tax legislation, with the aim of encouraging good-faith compliance by companies and thwarting arbitrary action by incompetent and/or corrupt tax officials. Ivanov noted that as a result, the number of tax-related lawsuits had fallen, as the *arbitrazh* courts had created a framework in which disputes between the Tax Service and corporate taxpayers had become fewer and could more easily be settled out of court.

At the same time, and perhaps as a result of the growing trust in the tax area, the overall demand for the services of the *arbitrazh* court system has risen strongly in recent years. In 2008, the total new caseload for the first time exceeded one million filed actions (a 13

per cent year-on-year increase). In the following year, that total jumped by a remarkable 45 per cent on the back of an avalanche of litigation related to credit defaults following the global financial crash. Although traffic fell again in 2010, the number of cases, at 1.2 million, was still 27 per cent higher than in 2007. (Incidentally, the share of legal actions brought by foreign entities has continued to increase gradually, to 0.3 per cent of the total in 2011, with 58 per cent of those 'foreign' claims being upheld.) Only a small (but growing) fraction of cases makes it all the way up to the SAC: 0.04 per cent of all commercial cases in the first half of 2011.¹⁸

¹⁸ All figures are from the SAC's official website: www.arbitr.ru.

Previous reforms helped *arbitrazh* court independence

The story of Ivanov's judicial reforms is largely contained in this small number of landmark cases that made it all the way up to the SAC. However, it is important to correct any initial impression that Ivanov inherited some kind of Augean stables. Since the decision in the early 1990s to detach specialised commercial courts from the general court system, the judges and staff of the *arbitrazh* courts – under the leadership of Ivanov's predecessor Venyamin Yakovlev – soon appeared more specialised and competent than most of their peers. This is not saying very much – as would be attested by those on the receiving end of the all too many highly dubious *arbitrazh* court decisions over the years. But given the challenge of constructing a legal system for a market economy in the post-Soviet void, the ring-fencing of commercial jurisprudence for separate development has proved sensible and far-sighted.

Important further reforms came in the early 2000s: first the adoption of the *Arbitrazh* Procedural Code which formally reserved to the *arbitrazh* courts all disputes related to business, finance and property; and second, the setting-up of an appeals circuit separate from the regional courts. Regional courts usually house both the first and appellate instance under the same roof. This means that both are equally subject to the often malign influence of regional

governments on which the judges depend for their careers and material well-being.

The significance of Ivanov's tenure as SAC chairman has been marked above all – as already indicated – by a series of fundamental rulings by the SAC itself. A key factor here is the criterion the SAC uses for accepting to hear cases. The SAC only considers petitions from the losing party in litigation that has already gone through full due process: the court of first instance, the court of appeal and, finally, the cassation court. Such petitions generally request that those verdicts be subjected to judicial review on the grounds that the lower courts misapplied the law. In a speech in March 2010, Ivanov referred to this practice of selecting cases for judicial review as the “filter”. He made clear that a key criterion in applying this filter, over and above standing up for particular litigants suffering from mistaken or improper lower court decisions, was the wider social and economic importance of the cases requesting a hearing in the SAC.

The VimpelCom case

The significance of this filter has been illustrated by the VimpelCom case, one of the more notorious examples of abuse in the Russian court system. The case arose from the dispute over VimpelCom, a major Russian mobile phone operator, and involved its two principal shareholders: Alfa, one of Russia's largest private business consortia, which held the controlling stake; and Telenor, the state-owned Norwegian telecoms operator, with a large (30 per cent) minority shareholding.

The dispute went back to 2004, when Telenor objected to an Alfa-inspired move by VimpelCom into the fast-growing Ukrainian telecoms market. Telenor reckoned that VimpelCom's planned acquisition of a Ukrainian mobile phone operator was overpriced. Alfa, meanwhile, accused Telenor of having the ulterior motive of suppressing competitive threats to Kievstar, Ukraine's largest mobile

telecom group of which Telenor was the controlling owner. What at first sight appeared to be a routine business conflict took on more sinister – and much wider – implications as a result of Alfa's ability to manipulate the lower *arbitrazh* courts.

A company that held just 0.0002 per cent in VimpelCom filed an action in a Siberian court claiming compensation from Telenor for profits foregone in the Ukrainian market. There was strong circumstantial evidence that this plaintiff was acting as a surrogate for Alfa. In August 2008, the court awarded damages against Telenor of \$2.8 billion. This was an outrageous ruling whichever way one looks at it – from the standpoint of fundamental legal principle down to details, such as the fact that the amount of damages fixed by the judge was based on an ‘expert’ opinion which cited the profits made by a comparable Ukrainian mobile phone company during the period in question, even though the figure given as ‘profit’ was in fact a loss.

This ruling was nevertheless upheld at appeal, triggering the start of enforcement proceedings against Telenor which, if completed, would have resulted in Telenor's being in effect expropriated: it would have had to sell its entire stake in VimpelCom to raise the funds to pay the awarded damages. The resulting harm to the Russian investment climate would have been disastrous. Telenor went on to lodge a final ‘cassation’ appeal in the federal *arbitrazh* court for the West Siberian district. It claimed that under Russian company law, a minority shareholder cannot be held responsible for decisions taken by a company's board and management. That cassation court repeatedly postponed its hearing on various technicalities.

In a newspaper interview in June 2009, Ivanov was asked whether the SAC was “getting ready” to hear the Telenor case. Naturally, he declined to be drawn into any discussion of the substance of the case. But he did give a signal by stating his view that Russian company law should go further in limiting the liability of minority shareholders while increasing that of controlling shareholders. And

he concluded by saying simply: “If the case reaches us, we will hear it.” In other words, had Telenor lost the cassation court appeal, the SAC would have intervened.

The case never reached the SAC, as shortly afterwards Alfa and Telenor settled out of court by agreeing to merge their entire portfolios of telecom assets in Russia and Ukraine. It was widely assumed in the market that such a settlement had been Alfa’s aim all along and that the purpose of the litigation was simply to ‘soften up’ Telenor ahead of that negotiation. While that assumption is most probably correct, Ivanov’s public signal about the SAC’s readiness to review the case must have reinforced Alfa’s motivation to settle. Had Telenor’s struggle continued through to a final victory in the SAC, this would have demonstrated for all the world to see that investors in Russia now have a last resort backstop against fundamental risks. As things turned out, the SAC’s positive influence was oblique. But plenty of more visible demonstrations of the positive contribution of the SAC to Russia’s investment climate have come out of its rulings.

The SAC supports property and creditor rights

In cases that did reach the SAC, its verdicts have not only regularly overruled the decisions of the lower courts; they have also, in the process, helped to shape the Russian legal environment. The following examples give a flavour of the impact that Ivanov’s SAC has had on the development of Russian law:

★ **Nationalisation.** In June 2008, the SAC intervened decisively on the issue of expropriation or nationalisation. The issue had been brought to a head by a series of legal actions filed by law enforcement and tax officials with the aim of expropriating defendants on the basis of article 169 of the civil code. This article states that property arising from transactions that “flout the fundamentals of law and morality” may be forfeited to the state. But it had often been used in mundane disputes over

alleged legal infringements. The SAC ruled that the state could not use article 169 to nationalise assets in commercial disputes on such routine charges as tax evasion. This case has perhaps been the single most important contribution by any Russian court to the defence of property rights.

- ★ **Trademarks.** In July 2008, Akai, a Singapore-based consumer electronics group, won a final victory in the SAC after a string of defeats in lower courts in its struggle to reverse a highly dubious decision dating back to 1992. At that time, bureaucrats at Russia’s Patent and Trademark Office had awarded the legal protection of the Akai consumer electronics trademark in Russia to a company called Akai Universal Industries, which had been registered in Hong Kong only one month before filing its application. Even given the confines of legal language, the SAC’s ruling contains scathing criticism of the behaviour of the lower courts and Patent Office officials.
- ★ **Credit recovery.** As the dust was settling after the initial impact of the global financial crash, many Russian industrial companies found themselves with deeply impaired balance sheets. However, creditors regularly struggled to get their money back as debtors resorted to spurious lawsuits that questioned the validity of the underlying credit agreements. Against this background, the SAC, in June 2009, instructed the subordinate commercial courts to stop debtors delaying such court rulings.

Also in June 2009, a lower *arbitrazh* court struck down a claim by the Amur Shipbuilding Company to oblige Sberbank to reschedule a Rb124 million (\$4 million) loan on the grounds that the financial crisis and recession constituted *force majeure* in the sense of article 451 of the civil code. A week earlier, Ivanov had argued that article 451 should not be used in this way.

★ **Unfounded gain.** In July 2009, the SAC supported IKEA, the Swedish furniture giant, which sought to overturn lower court rulings in favour of a toy retailer called Premier. Premier had claimed compensation of around Rb50 million (\$1.7 million) after being evicted from an IKEA-owned mall for non-payment of rent. Having paid for the fit-out of its own store before being evicted, Premier's compensation claim was based on 'unfounded gain' (article 395 of the civil code) on the part of IKEA. The lower courts had agreed with Premier's argument that its original preliminary lease agreement with IKEA was invalid because at the time of signature the mall was still under construction and IKEA was not yet its registered owner.

The SAC ruling states bluntly that the lower court's position on this point was "mistaken". It further ruled that article 395 is applicable only when the gain is monetary (rather than in kind – such as, in this case, a fitted-out retail space in a shopping mall). That ruling on the meaning and application of a whole article of the civil code now constitutes a precedent.

The SAC establishes precedent law

That word, 'precedent', brings us to the most important point of all. From early on in Ivanov's tenure it was clear that rulings handed down by the SAC had far greater significance than just the piecemeal and particular application to the specific cases in question (important as several of those cases were to the wider investment climate). These rulings increasingly guided the practice of the lower *arbitrazh* courts and thus had a systematic and positive influence on business practices and risks in Russia. But this practice started to be formalised in February 2008, when the SAC promulgated a general ruling that explicitly claimed the right to set precedent.

That right, the SAC went on to say, could be exercised in two ways: either through general interpretations of the law by a plenary session of the SAC or through the court's rulings in individual cases. This means

that a ruling by the SAC must be followed by a lower commercial court that is hearing a similar case. Moreover, the obligation of the lower commercial courts to abide by an SAC ruling was to have retroactive force, meaning that cases that had been closed could be reopened.

Now armed with the weapon of retroactive precedent power, the SAC did not hesitate to use it. Shortly after issuing the February 2008 resolution, the court ordered the reopening of a case involving energy supplies in Moscow. That move prompted the party that had previously won the case to turn to the Constitutional Court (the highest of all courts in Russia) to challenge the constitutionality of the SAC's asserted right to set legal precedents that have retroactive force. In January 2010, the Constitutional Court endorsed the SAC's power to establish precedent as being wholly in keeping with Russia's constitution (while somewhat restricting the retrospective force of precedents set by the SAC). The kernel of precedent can be found in post-Soviet Russia's constitution – specifically the right given to the Constitutional Court to interpret the constitution with binding effect on the other branches of power and the citizenry. So the Court really had no choice but to rule that the SAC has the corresponding power to interpret civil law, which is typically drafted in very general and abstract terms.

The benefits and risks of precedent law

The SAC's successful assertion of the right to make law by precedent constitutes a quiet revolution in various senses. Without any political declaration or fanfare or even prior legislation, the Russian legal system has shifted onto hybrid ground between the classic 'continental' European Roman law approach (in which courts apply codified laws to every individual case) and the 'Anglo-Saxon' style (in which judges rule in the light of both statute and precedent). The systematic introduction of precedent law into the practice of the *arbitrazh* courts could enhance legal certainty and reduce business and investment risks. At the same time, this fundamental reform also gives rise to some potential new problems and risks:

★ **Judicial creep:** Perhaps the most obvious point of contention – and one that is very familiar in the US context – is ‘judicial creep’, the risk that courts start usurping the competence of the legislative branch by shaping, rather than applying, the law. Ivanov has offered a twofold answer to this objection. First, and more conventionally, he argues that the general poor quality of primary legislation obliges the judicial branch to take on a quasi-legislative role. “Better legislation will reduce the scope and need for precedent law, and vice versa.”

His second argument is more ambitious. He expresses some scepticism about the superior status of lawmakers by dint of their being elected. He also conveys a lively sense of the dignity of the judiciary in various senses: as a branch of power established by the country’s democratically adopted constitution; as a body of officials (judges) appointed by democratically elected policy-makers (more below on the appointment process); and, above all as a collective bearer of the subjective values and goals of Russian society.¹⁹

¹⁹ *Vedomosti, February 16th 2011.*

★ **Judicial independence:** A second general problem with the introduction of precedent law is that it involves some sacrifice of judicial independence by binding the lower courts. A pragmatic answer may be that the reduction in the theoretically unlimited discretion that individual judges exercise in a Roman law system on a case-by-case basis is no great loss in the specific Russian context – where large numbers of judges (especially in the lower courts) are poorly qualified, often venal, and even more often vulnerable to pressure and intimidation from officialdom and/or unscrupulous private litigants.

To this, Ivanov has added an argument of principle: even when hearing a case that appears to be covered by a binding SAC-defined precedent, an individual judge can still find some new circumstance or nuance justifying a different decision. On being

appealed right up through the system, this different decision might finally be endorsed by the SAC itself.

★ **Abuse of power:** A final concern stemming from the Ivanov reforms is at once the most straightforward and the most imponderable: the risk that the small group of SAC judges abuse their enhanced powers. For now, this risk seems negligible. A good measure of comfort can be drawn from the track record of Anton Ivanov himself and the sure prospect of his remaining in charge of the SAC at least until 2017. (Russian judges can be dismissed in a lengthy process stemming from alleged criminal negligence or other felony, but this seems implausible in Ivanov’s case; and even the scenario of politically motivated allegations, which are common enough in Russia, seems far-fetched, given that Ivanov is part of the Putin-Medvedev establishment.)

That said, success increases the all-too-human danger of falling into the trap of overreach and hubris. Ivanov himself and/or his successor(s) might use the SAC’s enhanced power in a way that damages rather than helps the investment climate. But the nature of Ivanov’s achievement generates an organic barrier to this risk. Over time, the corpus of sensible precedent law will continue to expand; and, by that very process, the scope for arbitrary and abusive precedent will narrow. Put another way, it would take at least as many years for a malign SAC chairman to unravel the skein of investment-friendly precedents built up under Ivanov’s long tenure.

The positive assessment of Ivanov’s SAC does not hinge solely on the court acting as some kind of pro-business lobbyist, however. The SAC has handed down several important rulings that were pro-market rather than pro-business in a narrow sense. For example, in 2010 the SAC upheld a fine of Rb1.1 billion (\$38 million) that Russia’s competition regulator had imposed on TNK-BP, the British-Russian joint-venture oil company, for monopolistic pricing in

²⁰ *All the other big Russian oil companies were also subject to similar cases, the one against TNK-BP was simply the first to make it up to the SAC.*

various regional oil product markets.²⁰ Also in 2010, the SAC upheld a lower court ruling that had rejected a suit brought by a group of portfolio investors against the controlling shareholder of an electricity generation company (OGK-2). The latter had wriggled out

of its legal obligation to buy out minority shareholders on the cynical pretext that it was a foreign-domiciled company (as many Russian companies and holdings are for tax purposes or to disguise their true ownership structure). As such, the controlling shareholder claimed to be prohibited from going through with such a buy-out under the 2009 legislation restricting foreign investment in sectors defined as ‘strategic’, which also covers the power sector. The SAC’s ruling here implied that there is no scope for precedent-setting interpretation in such cases where statute law is explicit – even when the law in question is explicitly an ‘ass’.

Top-down reform can work

The review of Ivanov’s record as SAC chairman prompts a general reflection on Russian reforms: given the country’s historically-rooted political culture of strong centralised authority, structural reform in Russia is typically pursued from the top down. This is so even when such an approach is clearly unsuitable as, for example, in developing competing political parties. But judicial reform of the kind pursued by Ivanov is a rare example of an area where action by a few or even a single enlightened senior official can bring about real systemic change.

This effect can also be seen in the practical reforms that Ivanov has initiated to combat corruption in the *arbitrazh* court system by increasing transparency. The two most important reforms are both designed to make it harder to cover up arbitrary and corrupt rulings: first, the text of all decisions by any *arbitrazh* court at any level must be posted on the internet; and second, judges are now required to disclose (again on the respective court’s website) all approaches that

individuals and organisations have made concerning cases that the judges are hearing or might hear. Of course, this rule cannot in itself prevent corruption; but, in similar fashion to the new requirement for civil servants and law enforcement officials to declare their incomes, the habits and expectations of transparency will over time reduce the extent of false or non-disclosure.

Independence vs. accountability

Fortified by his growing authority, Ivanov is now beginning to apply the same approach of enlightened top-down action to aspects of judicial reform that extend beyond the *arbitrazh* courts themselves. His latest initiatives aim at reforming the processes for judicial appointments and disciplinary action, where a tricky balance needs to be struck between independence and accountability.

Under article 128 of the constitution, the Russian president appoints all judges – apart from members of the Constitutional Court, the Supreme Court²¹ and the SAC, who are nominated by the president and appointed by the Federation Council, the upper house of the Russian parliament. In practice, the president makes appointments on recommendations from appointments committees consisting of senior judges and officials.

²¹ *The Supreme Court is the highest court in Russia’s system of general courts, like the SAC is the highest court in the parallel system of commercial courts.*

The appointment process potentially opens the door to political pressure on judges, as illustrated by a 2008 case in which a high-level judge admitted to have come under pressure from the Kremlin. The case stemmed from the allegations of a well-known broadcaster, Vladimir Solovyov, that a Kremlin staffer called Valery Boyev had been intimidating the judiciary – and the *arbitrazh* courts in particular. Boyev worked in the Kremlin department processing judicial appointments and was reporting to Viktor Ivanov (no relation), a leading member of the *siloviki*. Following Solovyov’s allegations, Boyev filed a libel action against him. During the first

substantive hearing in court, the defence called as a witness Yelena Valyavina, the first deputy chairman of the SAC. Valyavina testified that Boyev had indeed put pressure on her in late 2005 to reverse a ruling that had frustrated a ‘raid’ (a predatory expropriation attempt) mounted against a large industrial enterprise (Togliattiazot, a bulk chemical producer). Boyev had threatened that her “inadequate understanding of state interests” might prevent her being re-appointed at the end of her term.

Anton Ivanov is now proposing a system that he suggests will make the process of appointing judges faster and more meritocratic, while also enhancing the independence of the judiciary. The plenums of the two top courts, the Supreme Court and the SAC, rather than the president, would appoint the heads of all courts as well as their deputies. The Supreme Court and the SAC would make these appointments on the basis of written evaluations of candidates by the heads of lower courts; those evaluations would be objective insofar as they would be based on assessments given anonymously by other members of the court or on a system of rankings. These anonymous testimonials would enhance accountability.

Judicial independence would be preserved by reserving final decisions to the judicial hierarchy itself rather than, as is now the practical reality, the Kremlin staff. In December 2011, a joint plenary session of the Supreme Court and SAC considered proposals on disciplinary procedures that are in a similar vein – that is, to make it easier to discipline (and ultimately remove) corrupt and incompetent judges while reserving final decision-making to the most senior judges in the Supreme Court and SAC.

This initiative raises a host of difficulties, with the most obvious risk being that of empowering the politically-appointed top judges in the Supreme Court and the SAC. This risk might look less severe if Russia continued down the path of greater political pluralism and if a Medvedev proposal on restoring the direct election of regional governors succeeded. Direct elections would give more teeth to the

Federation Council (composed of representatives of the regional authorities) that appoints the top judges. But just like Ivanov’s ideas, any proposal for judicial reforms would involve the challenge of improving the process of judicial appointments and making it easier to remove inept and/or corrupt judges but without (further) undermining the independence of the judiciary.

Never again Yukos?

A revival of political reform following the December 2011 protests could help to reduce the most fundamental risk to the rule of law in Russia, namely political interference in the decisions of the courts. There is the widespread practice of senior officials, whether in regional governors’ offices or in the Kremlin, pressing the ‘override’ button when they consider some political expediency more important than the rule of law.

The *locus classicus* here remains the case against the once mighty oil company Yukos. Yukos went bankrupt following a \$27 billion tax claim against it and the arrest of its senior executives, Mikhail Khodorkovsky and Platon Lebedev. These two have now been convicted on two sets of criminal charges and sentenced to a total of 14 years’ imprisonment. Arguably, the *arbitrazh* courts were compromised to a lesser extent in this sorry saga than the criminal courts (especially following the latest criminal conviction of Khodorkovsky and Lebedev in 2010 on the absurd charge that they stole all the oil that Yukos produced). And with every year that passes without a new Yukos affair being forced through the *arbitrazh* courts, the process of rebuilding confidence in the rule of law can continue. Moreover, the specific provisions of tax law that the *arbitrazh* courts had applied against Yukos have since been changed.

None of this proves that the Kremlin will never again press the political override button. By far the best defence against this risk, however, is institutional improvements in the functioning and organisation of the courts. And as regards the *arbitrazh* courts under

the leadership of Anton Ivanov, this is exactly what has been happening. Cementing this progress will increasingly depend on the political environment in which judicial reformers like Ivanov operate. Much hinges on the prospect of a more open and competitive political system that may emerge after the December 2011 protests. Unless this proves a false dawn, the Ivanov reforms will yield rich economic and social dividends during the rest of the present decade.

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CENTRE FOR EUROPEAN REFORM

Three views on modernisation and the rule of law in Russia

Christopher Granville, Philip Hanson and Alena Ledeneva

Edited by Katinka Barysch

Russia's leadership regularly promises to modernise the economy, fight corruption and strengthen the rule of law. The CER has asked three eminent Russia experts what, if anything, has been achieved and what needs to be done. Philip Hanson explains why top-down industrial projects of the kind championed by Vladimir Putin will not help Russia onto a sustainable growth path. Alena Ledeneva argues that informal networks and cronyism are at least as important for understanding Putin's Russia as formal hierarchies. Yet they are a lot harder to change. Christopher Granville highlights a crucial positive trend in Russia's otherwise difficult business environment: commercial courts are becoming more independent, reliable and transparent.

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