

Unwritten rules

How Russia really works

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THE CER'S WORK ON RUSSIA IN EUROPE

The CER has established a research programme on Russia's links with the European Union. This looks at what the EU can do to help Russia, as well as what Russia can do to help itself. It examines the economic reform process within Russia. The programme also looks at Russia's place in Europe's emerging security structures, including Russia's relationship with NATO.

The CER's Russian partner in this programme is the Moscow School of Political Studies, which has already translated several CER pamphlets into Russian, including David Gowan's recent *How the EU can help Russia*. The CER is grateful to Accenture and to BP for supporting its work on Russia. Neither company has asked for or had any influence over the editorial content of CER publications.

1 Introduction

“I am not in the least afraid of foreign capital, since I consider it is in the interests of our country. No country has been developed without foreign capital. What I am afraid of is just the opposite, that our way of doing things has such specific characteristics, so different from the way things are done in civilised countries, that not many foreigners will want to do business with us.”

*Sergei Witte, Russian Prime Minister
at the end of the 19th century*

There is a certain mythology that Russia is a land of irregularities and paradoxes, to a large extent impenetrable to outsiders. At the level of clichés, the “Russian soul” and “Russian chaos” are often given some implicit explanatory power. Appeals to a “traumatic past”, “kleptomania” or the “size matters” argument also frequently appear in this type of discussion. A common assumption behind these ideas is that there is some kind of disorder in Russia which makes it different and distinct from more orderly economies. A similar conclusion could be drawn from post-1998 analyses of the macroeconomic reforms introduced in Russia during the 1990s. These suggest that reforms did not work as expected, owing to the absence of the institutional framework required by a market economy, and to non-economic factors, such as a lack of civil society, civic responsibility and business ethics. Corruption has often been identified as a major, self-perpetuating source of problems. It seems impossible to combat corruption in a society where, supposedly, no agency or institution is free from it. As a result, it has become an accepted view that Russia’s economy is non-transparent – that is, it is an economy in which the “rules of the game” are not easily recognised or understood.

I will argue that in order to make the rules of Russia’s economy transparent, one should start by altering the approach. Rather than looking only at what does not work in Russia and why, one should

concentrate on what does work and how. This study is based on the assumption that there is order in Russia and that, however hard the effort, it is *possible* to grasp the logic and articulate the rules within that order.

Let me give an example. The ineffectiveness of the rule of law is one of the main obstacles to Russian economic and political development. Not only does the weak rule of law deter much-needed foreign investment, it

¹ K Hendley, "Legal development in post-Soviet Russia", *Post-Soviet Affairs* 13:3, 1997

also undermines efforts to tackle acute problems such as capital flight, tax evasion and abuses of corporate governance.

Many reforms have been designed to remedy the inefficiency of the rule of law, but failed at the stage of implementation.¹

Following our alternative perspective, one should ask: "If the rule of law does not work in Russia, then what does?" If legislative reforms and law enforcement do not operate in the expected way, it is logical to suppose that something is working against them, and working

very efficiently. What is it?

² According to *Interfax*, Vladimir Makarov, the deputy head of the Interior Ministry's economic crime department, said that up to 45% of the country's goods and services fall within the shadow economy, and that over 40 Moscow banks are currently involved in what he called "serious" shady deals. Also, Duma Security Committee chairman Aleksander Kulikov, told *RIA-Novosti* that the treasury receives only 5% of taxes due, because of operations in shadow economy (*RFE/RL Newswire* 5:28, Part 1, February 9, 2001)

A tentative answer can be found in popular wisdom: "Russia is a country of unread laws and unwritten rules." Or, as they say, "the imperfection of our laws is compensated for by their non-observance" (*nesovershenstvo nashikh zakonov kompensiruetsya ikh nevypolneniem*). It is not that the components of the rule of law are absent; rather, the ability of the rule of law to function coherently has been subverted by a powerful set of practices that has evolved organically in the post-Soviet milieu. Taking such an outlook as a point of departure, I will argue that the "rules of the game" in Russia can actually be understood if so-called "unwritten rules" are taken into account. If we adopt the perspective of unwritten rules and try to understand how they work, it may help to make the rules of the game more transparent, and therefore open to positive change and reform.

Given the scale of the informal economy in Russia, there is no shortage of examples that illustrate how unwritten rules operate.² Tax evasion practices provide an excellent ground for studying the informal order of things. On one hand, there are commonly used ways of reducing tax liability and evading taxes, which are considered detrimental to the functioning of the economy. On the other hand,

“saved” taxes are often used for investment, as there are few other sources of investment in the economy. What looks like capital flight can in fact reappear in the form of foreign investment. The fact that Cyprus is both the most popular offshore zone for Russian business and one of the country’s top five foreign investors, matching the level of France and the United Kingdom, is indicative of this.

In other words, the informal order balances the formal one. This accounts for why things in Russia are never quite as bad or as good as they seem, and draws attention to the unwritten rules that prescribe the ways in which the informal order of things interacts with and subverts the formal one. In a way, cases where taxes are negotiated, bargained over or subject to various allowances illuminate how Russia really works much better than those where taxes are simply not paid. Requests from tax officers for flat payments do not only happen around election time – according to *The Moscow Times*, this is now “standard operating procedure” whenever the government faces an unexpected expense. Bankers, industrialists and others will receive phone calls from high-ranking officials and be asked for substantial donations. The donors would be wise not to ask why – questions often lead to interference in their business, such as pressure to hand over shares to competitors or the state. Similar practices occur on a regional level.³

³ *The Moscow Times*,
November 9, 2000

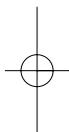
Another striking set of examples derives from the role of the state as a major shareholder in many large corporations. Insider deals have prevailed (particularly since 1995) as a method of state asset disposal, while other opaque corporate governance arrangements have proliferated. The latter are impossible to decode without understanding the logic of unwritten rules, just as it is impossible to fully decipher the “information wars” and “*kompromat* (blackmail files) wars” omnipresent in the press in the 1990s. Unwritten rules have also played a part in regulating non-monetary exchanges. Barter chains that redistribute income among the “inner circle”, as well as among firms and their multiple subsidiaries, have revolutionised practices of “give-and-take” and provided them with a seemingly legal form.⁴

⁴ *The inner circle normally includes top management, plus those who profit from barter – e.g. local authorities, private protection companies etc*

All of these phenomena share an important feature: agents at all levels employ practices that have come to be known as extra-legal or informal.



These practices are to a large extent responsible for the non-transparency of the “rules of the game” in the new Russian economy, mainly because they are regulated by what is referred to as informal arrangements, unwritten codes or unspecified rules. All these are elusive in nature and need further clarification.



2 Towards a definition of unwritten rules

Let us start with the notion of the “rules of the game” – a phrase which is often taken for granted. Nobel laureate Douglass North has defined institutions as the “rules of the game in a society or, more formally, humanly devised constraints that shape human interaction”.⁵ He distinguishes between formal and informal types of constraints, with both being components of institutions.

⁵ DC North, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, 1990

“They [institutions] are perfectly analogous to the rules of the game in a competitive team sport. That is, they consist of formal written rules as well as typically unwritten codes of conduct that underlie and supplement formal rules, such as not deliberately injuring a key player on the opposing team. And as this analogy would imply, the rules and informal codes are sometimes violated and punishment is enacted. Taken together, the formal and informal rules and the type and effectiveness of enforcement shape the whole character of the game”.

According to North, the “difference between informal and formal constraints is one of degree. Envision a continuum of taboos, customs and traditions at one end to written constitutions at the other”. Informal constraints are defined by codes of conduct, norms of behaviour and conventions. Underlying these informal constraints are formal rules, but these are seldom an obvious and immediate source of choice in daily interactions. Formal rules include political (and judicial) rules, economic rules and contracts, and they determine formal constraints. That informal constraints are important in themselves (and not simply as appendages to formal rules) can be observed from the fact that the same formal rules and/or constitutions imposed on different societies produce different outcomes.

Unwritten rules should not be confused with informal rules. Although the literal sense of being “written” or “unwritten” is an interesting dimension

of the analysis of formal and informal constraints, this is a dimension I shall ignore. What I want to explore here is the intuitive sense of the idiom “unwritten rules” – unwritten rules as meta-rules, or rules about the rules.

In this sense, unwritten rules are neither formal nor informal. To return to North’s competitive team sports analogy, unwritten rules are about the mastery of the game, including the skill of the players and the knowledge they possess of the game. Unwritten rules prescribe how formal and informal constraints can be circumvented or partially enforced. If the counterpart of informal rules is formal rules, the counterpart of unwritten rules is the “rules of the game” as a whole.

The “meta” nature of unwritten rules can be explained by distinguishing between rules and rule-following. Rules make one’s behaviour regular, recognisable and understood. If someone knows a rule, however, that does not mean that they necessarily have the ability to follow or master it; similarly, knowing a recipe does not ensure practical skill in its implementation, and knowing the literal meaning of a word does not automatically imply that one will use it correctly in context. In other words, rule-following implies a certain skill that can only be achieved through the practical experience of dealing with constraints. It is this practical knowledge of the rules of the game that makes one an expert in unwritten rules. The mastery of unwritten rules implies the following:

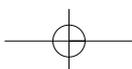
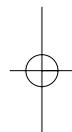
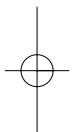
- ★ *Unwritten rules are the know-how needed to “navigate” between formal and informal sets of rules, and between the rules and their enforcement.* Without being articulated, they “prescribe” which rules to follow in which context and “set” the best approach for getting things done. Applying one formal rule rather than another, using restrictions and small print, or enforcing some decisions but not others are examples of how constraints can be manipulated. The focus of unwritten rules is not on constraints *per se*, as in the case of formal and informal codes, but on the enabling aspects of those constraints. To put it more bluntly, unwritten rules define the ways of circumventing constraints, both formal and informal, of manipulating their enforcement to one’s own advantage, and of avoiding penalties by combining the elements of the rules of the game creatively.

- ★ If we distinguish between organisations as enforcing mainly formal constraints and social networks as enforcing mainly informal constraints, *unwritten rules regulate the ways in which organisations and networks interact*. In other words, they shape the interaction between organisational principles and ties of kin and friendship. For example, the ways in which old-boy networks or nepotism permeate modern institutions are guided by unwritten rules. Soviet *blat*⁶ – the widespread use of personal networks to obtain goods and services in short supply – is a classic example of unwritten rules, according to which resources from the formal distribution system were siphoned into informal networks. *Blat* had a function in the Soviet system, as it helped to lubricate the rigid constraints of the formal economy. In present-day Russia, unwritten rules bridge the formal and informal sectors of the economy, and prevail in areas vacated by the state but not yet filled by civil society. Thus they deform both the formal system of governance and the informal networks.

⁶ *Blat is an informal exchange of favours, pervasive in the Soviet economy. See A Ledeneva, "Russia's Economy of Favours: Blat, Networking and Informal Exchange", CUP, 1998*

- ★ Unwritten rules exist in all societies,⁷ but predominate (and even become indispensable) in those *where enforcement and formal and informal rules are not synchronised and do not constitute coherent rules of the game*. North shows that when people perceive the structure of the rules of the system to be fair and just, transaction costs are low and enforcement costs are negligible, which contributes to the efficiency of the economy. When people perceive the system to be unjust, the cost of transactions goes up. In other words, if one cannot follow both formal and informal sets of rules coherently, this will be reflected in their merging and in certain patterns of rule-following, or unwritten rules. It might be tempting to think that unwritten rules are generally disadvantageous for the system. This is only true, however, if the rules of the game – formal and informal constraints and their enforcement – further the public interest and are beneficial to economic performance. As this has not always been the case in Russia, the impact of unwritten rules is rather ambiguous.

⁷ *Oxbridge unwritten rules are spelt out in FM Cornford, "Microcosmographia Academica", New York, 1964*



3 Why are unwritten rules prevalent in Russia?

Reliance on unwritten rules is an outcome of the inefficiency of formal rules and the mechanisms for enforcing them, on one hand; and people's lack of respect for formal rules and their exploitative attitude towards formal institutions on the other. Correspondingly, we should consider two fundamental sets of factors when explaining why unwritten rules are so prevalent in Russia. One set derives from the nature of future-oriented formal rules – that is, the legislation designed to change the political and economic order in Russia, and the loopholes in its formulation and enforcement. The other is related to the nature of informal rules and the legacy of the past, which continues to shape today's practices. Let us consider these factors, starting with the nature of formal constraints and the problems of Russia's legal framework.⁸

⁸ I do not consider issues related to lobbying or the elaboration and adoption of legislation, which reflect various international and domestic pressures, as I am most concerned with practices affecting the existing legal framework. The weakest areas of legislation awaiting attention are minority shareholders' rights, creditors' rights, intellectual property rights, and the land code

First, there is the inconsistency between different kinds of legislation, such as laws (*zakony*), decrees (*ukazy*), resolutions (*postanovleniya*) and instructions (*rasporyazheniya*). For example, Yeltsin's presidential decrees often contradicted Duma legislation and were sometimes used to sidestep obstructionist moves by the legislature. When the World Bank interviewed members of the business community in the summer of 1999, about one-third of the respondents said their firms were harmed by the president's decrees – laws which were seen as beneficial to oligarchs or individuals closely linked to the government. Decisions taken at the sub-federal level often openly contradict federal law but go unchallenged. In February 2001, First Deputy Prosecutor-General Yuri Biryukov reported that his office had uncovered 3,273 “illegal acts” by regional governments over the previous six months and that regional governments continued to “write laws as they wish”.⁹ The insufficient synchronisation of federal and local legislation has also been reported by regional

⁹ Nezavisimaya Gazeta, February 28, 2001

authorities. In the same month, the first deputy prosecutor in the republic of Sakha, Nikolai Takhvatulin, said that in 1999-2000, local prosecutors “appealed to republic-level officials 90 times about 43 laws and 35 decrees

¹⁰ RFE/RL
Newsline 5:32,
Part 1, February
15, 2001

which violate federal legislation. As a result, some 34 laws and 22 decrees were changed”.¹⁰ The continued existence in Moscow of the Soviet-style residence permit (*propiska*) violates federal law, despite the decision of the country’s Constitutional Court to ban such practices in 1996. There are other well-known examples of the inconsistency between the 1993 Constitution, the Civil Code and other forms of legislation, especially in areas of taxation, licensing and registration.

Second, there are issues related to enforcement:

- ★ Some of these are related to the generally weak enforcement infrastructure. The Russian government has failed in its responsibility to collect tax revenues, to maintain a social safety net, to enforce laws and agreements, to ensure the physical safety of its citizens and to provide the necessary conditions for a transition to a market economy. Formal institutions, including the judiciary, are widely seen as corrupt and self-serving, incapable of fulfilling their obligations to the citizenry and unworthy of popular respect.
- ★ The inefficiency of the government in providing services to the private sector has facilitated the emergence of alternative institutions that operate with more efficiency, often by using methods that are not fully legitimate. Various security departments and private protection firms, often consisting of ex-employees of the state’s coercive ministries, have assumed the function of enforcing laws and contract relations in the private sector of the economy.
- ★ There is also a strong regional dimension to the problem of enforcement. Laws that are on the books are applied unevenly and arbitrarily in different areas of the country. Regional governors dominate the regional prosecutors, courts, militia and units of the security services, effectively fracturing the coherence of these organs of federal power. The impossibility of resolving disputes through formal procedures means that many problems get solved outside the legal domain and by unlawful means.

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- ★ The above factors have led to a situation where the law is used as ammunition in the fighting of business wars and in regional-federal battles. There are plenty of instances where attempts to enforce the legal order have been motivated not by the logic of law, but by commercial, political or personal interests. It is fairly regular for legal sanctions to be imposed in the pursuit of an informal request. In such cases, the particular act of law enforcement is just one link in a complex scheme of backstage commercial or political operations, as happens rather often with insolvency cases.

Third, the implementation of legislation depends on the cultural context and public support for the rule of law. Cultural tradition, however, separates the concept of justice from that of formal law, which is highlighted by the diverging connotations of the words *spravedlivost* (justice) and *zakonnost* (lawfulness). In his study of *Muscovite Political Folkways*, Edward Keenan explains this gap between the informal and the formal in terms of political culture.¹¹ He argues that Russian political culture has been strongly influenced over time by both the psychological attitudes and by the practical, adaptive techniques that were developed by the earliest Slavic settlers. The economic and social conditions that they faced – isolation, poor land, a severe climate, unpredictable harvests and a generally hostile environment – gave rise to a vigorous culture with specific traits: caution, calculation, resoluteness, stoicism, endurance and, above all, an emphasis on survival. Over the centuries, Keenan claims, these traits manifested themselves in the three distinct but compatible cultural settings of medieval Muscovy: the peasant village, the tsarist court and the bureaucracy. These share certain common features which constitute the enduring elements of Russian political culture:

¹¹ *The Russian Review*, Vol 45, 1986

- ★ the operational basis of each setting is informal and traditional (there is a lack of connection between real power and formal status);
- ★ decision-making is “corporate and conspiratorial”;
- ★ stability and risk-avoidance are favoured over innovation and progress; and
- ★ there is a reluctance to promulgate systematic codified law (those who need to know the rules know them).

Keenan suggests that the peasant, court and bureaucratic cultures fused during the Soviet period – especially under Stalin and thereafter – in a way that strengthened and purified the “deep structures” of Russian society in a modern regime: a strong leader and the “inner circle” (“grand prince and boyars became general secretary of the Communist Party and Politburo”), conspiratorial politics and pervasive informality (“it is more reliable to depend upon informal and personal relations than it is to rely upon the impersonal legal procedures and institutions that are favoured in other societies”).

Keenan’s conclusions about the nature of the Soviet system – his analysis predated the end of the USSR – also have relevance for our examination of the post-Soviet era. Distant and sceptical attitudes to the law have produced a fundamental problem of public governance. Disregard for the law is coupled with disregard for the state. The state is partly responsible for this attitude.

Over the course of the 1990s, the public felt betrayed by the outcomes of privatisation and placed all the blame on state institutions and bureaucrats, who found ways to prosper while abandoning the population at large to its own devices. A widespread sense of injustice fuelled the use of informal practices. For instance, before recent tax reforms, the nominal rates of all taxes often implied cumulative taxation of more than 100 per cent of revenues. Economic agents, who feel compelled to evade taxes, blame the state for forcing them into such a position. The state is scapegoated as corrupt and incompetent, further diminishing its legitimacy and deepening attitudes of civic passivity. When taken together with deep-rooted historical legacies, these tendencies foster unwritten rules and pose serious obstacles to the development of the rule of law, a fully-fledged democracy and a market economy.

Thus, as long as the conditions that make the rules of the game dependent upon unwritten rules persist, the prospects for transparency in the Russian economy are grim. Let me summarise the nature of this dependency:

- ★ *The “rules of the game” in the economy are non-transparent and frequently change*, because the existing legal framework does not function coherently. Some of the key building blocks of a transparent market system, such as a land code, anti-corruption legislation and

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a functioning banking system, are not in place; while basic market institutions such as open competition, property rights and transparent corporate governance do not work as they should. The incoherence of the formal rules forces almost all Russians, willingly or unwillingly, to violate them and to play by rules introduced and negotiated outside formal institutions.

- ★ *Anybody can be framed and found guilty of some violation of the formal rules*, because the economy operates in such a way that everyone is bound to be involved in some misdemeanour. For example, everybody is forced to earn in the informal economy in order to survive – a practice that is punishable, or could be made so. Businesses are taxed at a rate that forces them to evade taxes in order to do well. Practices such as the embezzlement of state property or tax evasion become pervasive. Inside state institutions, a whole family of corrupt practices, such as bribe-taking and extortion in the granting of licenses, has been prevalent. The fairly ubiquitous character of such practices makes it impossible to punish everyone.
- ★ *Due to the pervasiveness of the offence, punishment is bound to occur selectively*, on the basis of criteria developed outside the legal domain. While everybody is under the threat of punishment, the actual punishment is “suspended”, but can be enforced in principle at any time. The principle of “suspended punishment”, whereby a certain freedom and flexibility did exist but could be restricted at any moment, worked well in the Soviet system. It became routine practice for the authorities to switch to the written code only “where necessary”. A similar tendency is noticeable at present, and apparently for the same reasons: the formal rules are impossible to follow and and it is not feasible to prosecute everybody.
- ★ *Unwritten rules come into being to compensate for the defects in the rules of the game and to form the basis for selective punishment*. The violation of unwritten rules can result in the enforcement of written ones, which paradoxically makes it more important to observe the unwritten rules than the written ones. This, in turn, feeds back into the non-transparency of the “rules of the game” in the Russian economy.

These attributes of the system have not changed much during Russia's

transition to a market economy. In the same way that the planned economy was not really a planned economy and was actually run with the help of *tolkachi* (which literally translates as “pushers” and means fixers), *blat* and other informal arrangements, the market economy today is not really a market economy. This is due primarily to the key role that unwritten rules still play in the system.

Some Moscow observers note that, under President Vladimir Putin, the law enforcement agencies remain selective: they appear to pursue corruption allegations almost exclusively when they involve known opponents of the Kremlin.¹² A variety of “official” legal, administrative and economic sanctions can be used against “selected” victims. To start with, the fire brigade, tax police and sanitation department can be called upon to investigate tax irregularities or violations of fire, safety and public health codes. If necessary, this can be followed by a whole menu of further

¹² *The theme of selectivity has reached the Western press: The Economist, “Democracy in Russia: How free is free?”, November 2000; The Washington Post, “Selective Persecution”, November 17, 2000; Libération, “La lutte sélective de Poutine contre les ‘oligarques’”, November 17, 2000. Also The New Statesman, December 25-January 1, 2001; Business Voice, December 2000/January 2001*

sanctions, ranging from informal arm-twisting or negative publicity in the press to legal charges.

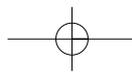
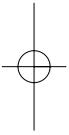
Such measures have been employed against media magnate Vladimir Gusinskii, who became the first “selected” victim of the anti-oligarch campaign which began in the summer of 2000. Yet Roman Abramovich, an ex-ally of oligarch Boris Berezovskii, was allowed without hurdles to proceed with an aluminium merger, creating a group that controls three-quarters of Russia’s total production. He won a seat in the Duma in December 1999 and became governor of the Chukotka region in December 2000. Thus, despite claims that no exceptions would be made for oligarchs and that they would be governed by the principle of equality in the face of the law, some oligarchs inevitably turn out to be more equal than others.

The problem is that even the best attempts to restructure the rules of the game by changing the formal rules can have only a limited effect. This is partly because efforts from the top cannot, at present, be sustained. And partly because any change in the formal framework introduces yet another constraint to be dealt with informally; this often results in the readjustment and reconfiguration of unwritten rules, rather than reducing their significance as a source of non-transparency of the rules of the game. Thus, unless we make an effort

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to understand the unwritten rules, further reforms in Russia are likely to lead to an endless string of frustrations. Before we discuss how to change the unwritten rules and thus increase the transparency of the Russian economy, let us consider some of the ways in which these rules are applied in practice.



4 Unwritten rules in practice

Many people concentrate so heavily on what does not work in Russia that one might wonder how anything works at all. Yet the Russian economy does function, and in many instances with surprising results. While the economy most certainly does not operate in a transparent way, or in accordance with western market norms and standards, economic agents succeed in finding ways of enriching themselves – generally with an expertise in unwritten rules. The resulting picture may not be a “clean” one, but it does illustrate the fact that informal techniques often prove more reliable and efficient than formal procedures for solving problems and completing economic transactions.

It is in the nature of unwritten rules to stay unwritten. Thus they elude any context-free formulation and, if this is attempted, the result risks sounding trite. The closest one can get to illustrating the workings of unwritten rules is to identify practices where these rules are followed. Let us consider a few such practices, which both help the new Russian economy to function and impede the transparency of the rules of the game.

The practices that are most enduring and not particularly influenced by legislative changes are those based on false reporting. These are fairly universal around the world, but were “customised” by the Soviet past. In the planned economy, false reporting was employed to keep plan targets low and secure bonuses for over-fulfilling the plans. Now, the comparable practice of not declaring one’s profit is a major technique for hiding income and reducing tax liability. Just as pervasive are the related practices of double book-keeping (e.g. keeping inflated accounts for the use of fuel allows one to sell some of it privately) and document falsification (e.g. counterfeit contracts, fake invoicing and false offsets). Firms also resort to practices of backdating, often with considerable wit and imagination, in essentially fraudulent activities. For example, a transaction can be deemed void because the signatory to the deal had already been sacked, when in fact the dismissal order has been backdated. Or a contract can be considered to be counterfeit because an old stamp was used, when in

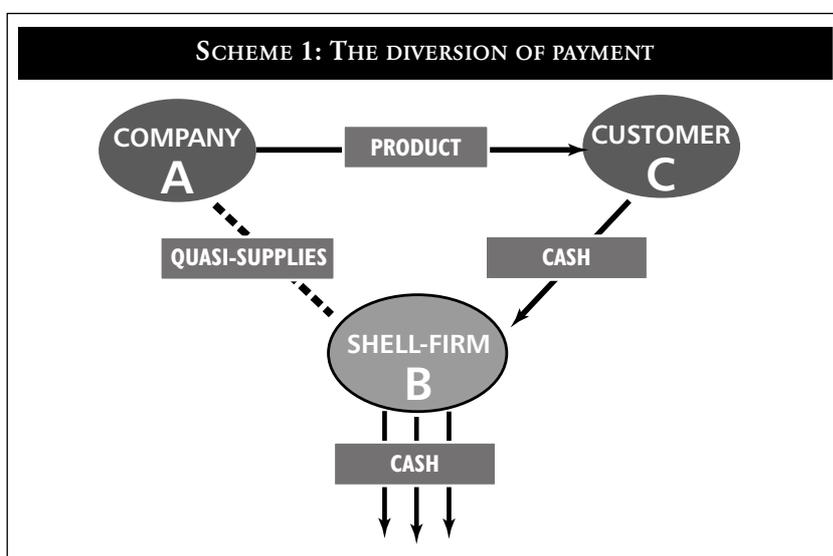
fact the firm wishing to annul the contract has intentionally replaced its stamp.

Some newer practices have come into being as a response to market reforms, and are flourishing in the loopholes of the new legal framework. The most damaging for the transparency of the new Russian economy are practices based on the so-called “corporate identity split”. What this means is that firms insulate themselves by creating at least two front companies and various shell-firms (*levye firmy*), scam-firms (*pustyshki*) or monkey-firms (*martyshki*), which are organised in a sophisticated financial network. Specially established offshore companies conduct financial transactions in order to reserve profits for an insiders’ club of shareholders or managers. The insiders’ club is organised according to another “splitting” principle – that of the *matryoshka*, whereby a bigger *matryoshka* is owned by the smaller one inside it, which is in turn owned by a smaller one inside it, and so on – making ownership difficult to trace. The book by Paul Khlebnikov, *The Godfather of the Kremlin*, claims that this is the organisational principle of the Berezovskii empire. According to Khlebnikov’s sources, the ownership ties of AvtoVAZ, the giant auto company that accounted for half the Russian market for passenger cars, are linked to the company Forus Services SA in the town of Lausanne, Switzerland, which was owned by Forus Holding (Luxembourg), which in turn was owned at least partly by a Lausanne shell company named Anros SA.

Together, these practices have produced a hybrid phenomenon – financial scheming. Financial schemes are intricate and convoluted mechanisms, deliberately non-transparent and intended to mislead and misrepresent the true state of affairs. The most elaborate schemes involve multiple transactions between upwards of a dozen ostensibly independent economic agents. Yet despite their complexity, financial schemes are used almost universally and guided by a simple principle – the diversion of payment. It is based on the following premise: if you have money, you should pretend that it doesn’t really belong to you or that you owe it to somebody else. This idea transforms every transaction into a circular chain, as shown in Scheme 1 on the next page.

When Company A (a real producer) supplies its product (e.g. parts for metal-cutting equipment) to a Customer C, payment for the product is

made to shell-firm B, established by Company A's owners or managers. Often, such shell-firms have no physical presence; they exist only on paper and with the help of a handful of official stamps and letterheads. Company A's shell-firm B forwards the payment from customer C to procure supplies for Company A's production needs in "black cash". The contract between Company A and the "quasi-supplier" shell-firm B is fake. On paper, Company A appears to be an intermediate distributor, rather than a producer of goods, and its financial turnover and tax dues are minimal.



The principles of false reporting, "corporate identity split" and diversion of payment, which underpin many schemes in the new Russian economy, have important implications for its non-transparency:

- ★ The official documentation that backs up these transactions does not reflect the real flow of resources. The transactions themselves seem absurd: the real seller does not get any money, the recipient of the money often exists only on paper and, as it often happens in complicated chains, the buyer does not really need what it bought.
- ★ These chain schemes undermine the basic economic distinction between sellers and buyers, which creates a lot of confusion:

diversions of payment are interpreted as trade credits, with consequences for the collection of statistics, and so on.

- ★ The chain schemes also indicate why decrees and changes in economic legislation have little direct influence on real economic processes in the shadow economy. Being protected by non-existent economic agents (shell-firms), real economic agents either avoid appearing on paper altogether, or refrain from showing real transactions and real volumes. Thus, regulatory changes may considerably influence the “paper” level of transactions, but they may not necessarily reach the level of real economic agents.

Making financial schemes transparent

In order to decode a scheme, one has to establish the true identity of all the agents involved and the connection or relationship of control between them, and also to uncover its functions. According to Yulia Latynina’s account in *The Moscow Times*, all of Aeroflot’s hard-currency turnover passed through two Swiss companies, Andava and Forus, and probably stayed abroad. Nikolai Volkov, the former lead investigator on the case, reported that “Aeroflot engaged a Russian company called FOK to collect its foreign debts. FOK, in turn, hired an Irish offshore company which collected the money from Andava. Naturally, FOK, the Irish company and Andava [were] controlled by the same people (78 per cent of the shares belonged to one of the heads of Aeroflot, and to Berezovskii). In this particular case, FOK and the Irish company collected spectacular fees of \$38 million. Basically, this was a scheme whereby Aeroflot borrowed its own money and paid a percentage for the privilege”.

Did Berezovskii’s people do anything illegal? No. There is no law against paying a middleman to perform a service, no matter how ridiculous the

¹³ See article by service or how high the fee. Latynina, a journalist and the author of a series of fascinating “economic thrillers”, argues that this kind of scheme is routinely used. The same pattern applies to Sibneft, Tyumen Oil or Norilsk Nickel, where Andava is replaced by such companies as Runicom, Crown Trading and Finance, and Norimet.¹³

To establish the identity of offshore companies and other links in a chain is a daunting task. It is normally true that the more successful the

enterprise, the more complex its “identity split”. In the most elaborate cases, financial flows link the main enterprise with its “pocket bank”, its *veksel* (bill of exchange/promissory note) centre, and more than a dozen firms whose functions are known only by top management.

Although the activities described above are directly related to tax evasion and capital flight, Latynina’s commentary strongly implies that this is what good companies do. First, in order to earn “big money”, a company needs skilled, qualified management. Second, the revenues generated must be concentrated in foreign companies, otherwise the efforts of the managers will come to nothing and any profits will be consumed by Russian taxes. To evade or, rather, to avoid taxes a company has to simulate arrears. In her *Okhota na Izyubrya* (The Deer Hunt), Latynina covers a variety of financial schemes that serve such a purpose. For example: an enterprise X sells its product to a Cyprus firm Y, at a low price (in order to avoid making any profit), and firm Y pays it back in 180 days. Meanwhile, enterprise X takes a loan in dollars from its own “pocket” bank Z at an inflated 60 per cent per annum. When the money comes from firm Y, it is shifted immediately to repay the loan to bank Z. If the money is kept in the enterprise’s account, it will be levied as tax and, Latynina argues, the taxes will be stolen, as happens with all government funds. If the money goes offshore, it does not get stolen but comes back to the enterprise.

From a company’s perspective, financial schemes can be divided into two broad classes. Some are designed to organise a company’s *internal* finances, i.e. to minimise taxes, divert profits and confuse outsiders. Normally, these involve “satellite” firms which belong to a director either directly or through people he/she controls, as in the examples above. Others are designed to organise *external* deals: outgoing capital flows and payments for the services of important external institutions (the customs, railways, regional administration, private protection companies and so on). These schemes make use of intermediate firms in order to pay for services, offset taxes, pay for protection or transfer bribes and political payments.

Latynina provides fascinating fictional accounts of possible uses for such intermediate structures. She explains how government funds can be diverted in order to finance election campaigns. For example, RAO

Atomenergo has a subsidiary, AtomStroiFinance, which issues promissory notes, which are used by Atomenergo to pay the builders of an Atomic Electric Station. The builders sell these promissory notes on the market at 18 per cent of their nominal value. They are purchased by a number of individuals and organisations. These organisations and individuals bring the promissory notes to Atomenergo, which buys them in cash at their nominal value. As the director of Atomenergo is a member of the Communist Party, the list of individuals includes Communist deputies and other “opponents” of Russia’s corrupted capitalism. This money serves the needs of the party. In effect, the whole Atomic Electric Station project is used to launder money intended for the elections.

The functions of financial schemes are too varied to describe exhaustively. Let us focus on financial schemes used for cash-flow stripping, asset stripping and diluting shares – areas of corporate governance most associated with the non-transparency of the Russian economy.

Playing with capital: cash-flow stripping

As shown in the examples above, a typical scheme is for managers to divert payment to a shell-firm, which serves a variety of functions. The use of shell-firms for tax evasion is best described by Yakovlev.¹⁴ I will concentrate on issues of capital flight. In cases of capital flight, payment is diverted by selling products to one’s own intermediate firms (or foreign partners) at low prices and transferring the proceeds to offshore companies. These funds can then be used to serve the needs of the original firm (e.g. to import equipment), or they may simply “disappear”.

¹⁴ A Yakovlev, “*Pochemu v Rossii vozmozhen bezriskovyi ukhod ot nalogov?*”, *Voprosy Ekonomiki* 11, 2000

¹⁵ V Tikhomirov, “*Capital flight from post-Soviet Russia*”, *Europe-Asia Studies* 49:4, 1997

The evolution of these schemes for exporting capital through foreign trade began with barter in 1991-93. These schemes relied on mispricing goods in barter exchanges. Exported Russian goods were deliberately priced lower, while imported goods were deliberately priced higher – the exporter usually “received an additional payment from his foreign partner through a money transfer to his private account in a foreign bank or through an unregistered (cash) payment in Russia”.¹⁵ Barter trade often involved a sequence of companies in different countries and elaborate financial schemes; this process was facilitated by the “absence of proper customs and border controls” between former Soviet states.

With the further development of the financial sector around 1993, *sham credit schemes* emerged. Tikhomirov describes sham credit as a “semi-legal scheme...[in which] a Russian-based company failed either to receive payment for commodities supplied to a foreign partner or to receive goods from abroad after making all the necessary payments. In both cases, the foreign partner (usually a small company established by Russian emigrants or by locals with the help of Russian-connected capital) disappeared, leaving the Russian company with ‘losses’.”

Later, *double invoicing schemes* began to take over as a favourite form of capital flight, as the government took steps to regulate barter deals and shady financial and trade deals such as sham credits. According to Tikhomirov, double invoicing requires a close business partnership between Russian and foreign companies, and is based on a high level of trust. It essentially involves signing two contracts for the same deal: the “official” contract is used for reporting and taxation; the second, “unofficial” contract sets out the split in profits between the two colluding parties. The foreign partners take part of the earnings as payment for their “services”, while the larger part is transferred into accounts held by Russians in foreign banks.

The constraints of having to rely on foreign partners and produce for export (such as complications with transport, customs and licences) have produced more sophisticated schemes for exporting capital without involving foreign trade. Recent schemes do not involve any export production and permit rouble income to be transformed into US dollars almost directly – that is, without intermediate transactions involving products or material resources (for details of such a scheme see Box 1 on the next page).¹⁶

¹⁶ See S Aleksasbenko et al, *Obzor Ekonomicheskoi Politiki Rossii za 1999 god*, Moscow, Bureau of Economic Analysis, TEIS, 2000

BOX 1: CAPITAL FLIGHT SCHEME (SIMPLIFIED)

Enterprise A wants to transfer some funds to a foreign account. Legally, such a transaction is restricted by regulations on currency conversion and bank transfers.

Step 1. Creating a regional monkey-firm

Enterprise A registers a firm, M1, usually in the corrupt area K. According to the contract signed between A and M1, A pays M1 \$1 million for fuel oil supplies.

Step 2. Linking the monkey supplier with a real supplier

The firm M1 is actually an intermediary – it does not produce anything. M1 subcontracts Enterprise B, which is controlled by A, to supply the fuel oil to A. M1 pays B with promissory notes (veksels).

Step 3. Creating a central monkey-firm and setting up the real supplier

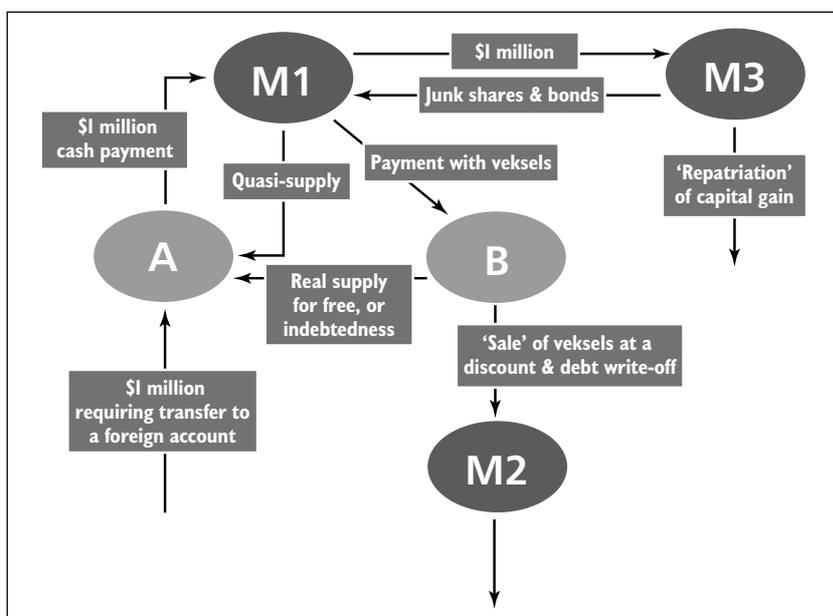
Enterprise B sells the promissory notes at a generous discount to M2, a firm which is created in order to have access to an account with a large commercial bank. M2 will never use those promissory notes, so that they are removed from circulation and can be written off as a “little debt” when M2 is liquidated a couple of years later. As a result, Enterprise B either has to supply its product for free, or must become indebted to A (which can serve as the basis for launching an insolvency procedure).

Step 4. Creating an offshore monkey-firm

An offshore firm, M3, is registered in Cyprus. With a minimal sum, M3 opens a special investment account “I” in a large bank in Moscow. There are no limits on the repatriation of capital back to Cyprus with “I”-type accounts. Money from this account is supposed to be spent on “portfolio investment”, which in this scheme means purchasing “junk” shares in Russian enterprises.

Step 5. Linking the offshore monkey-firm with the regional monkey-firm

Some of the “junk” purchased by M3 is sold to M1. The latter pays with its \$1 million, which get transferred from the regional bank account to the “I” account in the large Moscow bank. In other words, the Cyprus firm makes an investment and repatriates the capital gain (capital gain was not adequately taxed until 2000).



Since 1992, the government has been making efforts to control capital flight in two ways: by attempting to modify Russia's financial system and currency regulations, and by developing state controls over foreign trade. At worst, these measures have been ineffective, because they presumed the existence of a system of bureaucratic control which was not in place. Instead of curtailing capital flight, such measures spread corruption from the foreign trade sector into other areas, such as the bureaucracy and, later, the banks. At best, these measures have prompted financial schemes to become more intricate, and have thus had only a marginal impact upon capital flight from Russia. Meanwhile, a major contributing factor to the problem of capital flight – the low level of public trust in the government and Russian financial institutions – has not been adequately addressed. Many people think that keeping their money in foreign accounts is safer than investing in their own economy, while managers have their own “objective” reasons for depriving shareholders of their dues.

Playing with assets: asset stripping

Another method that is widely used to deprive shareholders of their dues is asset stripping. Either financial schemes or the help of a co-operative board of directors, can circumvent the restrictions on the sale of a

company's assets by its directors. In October 2000, in the run-up to a Gazprom board of directors' meeting, the five government representatives on the board (out of 11) were upset by the recent transfers of large chunks of Gazprom shares to other companies. A large contract had been signed with Stroitransgaz, the bulk of whose shares were held by relatives of Gazprom management. According to the 1999 books, approximately 50 per cent of Stroitransgaz's shares were held by those close to the upper echelons: 6 per cent by Vitalii and Andrei Chernomyrdin (sons of former Gazprom CEO and prime minister Viktor Chernomyrdin), 6.4 per cent by Tatyana Dedikova (daughter of Gazprom CEO Rem Vyakhirev), 20 per cent by Arnold Becker (General Director of Stroitransgaz and one of the Gazprom directors), and another 12.3 per cent by three of Becker's relatives.¹⁷

¹⁷ www.gazeta.ru
October 25, 2000,
News at 17:45

It is important to note that asset stripping can be instrumental in “defending” a company's assets from a takeover. When a rival tries to gain control of a company through insolvency procedures (which can be done rather efficiently under certain circumstances) and it is known that the court's ruling would be prejudiced in favour of the takeover, the company management may strip the company of its assets ahead of the takeover. The ownership structure can be manipulated. Company buildings and residences can change hands through diversion of ownership. All contracts with payments outstanding to the company can be consolidated in a “shift-a-debt” contract (*pereustupka prav trebovaniya*: an assignment of receivables), so that any incoming funds will be transferred to some other firm belonging to the management indirectly. If the company holds more than a 51 per cent share in any of its subsidiaries, this must be reduced to 25 per cent minus 1 share, so that the acquirer cannot get hold of the subsidiary. In rare cases, the deliberate insolvency of company subsidiaries can be engineered, followed by the exchange of their devalued shares for shares in holdings belonging to the management and its inner circle.

Playing with shares: diluting shares

Investors have often seen their shares diluted by controlling shareholders – a favourite practice of majority shareholders, aimed at strengthening their control over the company. Additional share offerings (regardless of the real capital market situation) are usually subscribed by “friendly” structures. When a new offering is aimed at the inner circle or controlled

firms on a “rouble for a kopek” basis, existing shareholders are disadvantaged. Such insider trading and abusive self-dealing often takes place at the expense of foreign investors or minority shareholders.

In order to achieve this, small shareholders are usually not informed about the initial public offering (IPO) of the company’s equity. Shareholder meetings are held at places and times that make them inaccessible for many shareholders. Procedural requirements for voting during the general meetings are not observed, and shareholders may be prevented from voting on a variety of grounds. Shareholders may not receive advance notification of the AGM agenda. Other strategies include shareholder agreements that are designed to redistribute control, risk and formal rights in equity ownership.

To defend or expand one’s business in Russia today requires a certain mindset, perhaps incompatible with transparency. A lack of transparency in corporate capital arrangements – for example intricate patterns of cross-ownership – is viewed as a form of self-protection against hostile takeovers and other risks.

In the above analysis, we have focused on those aspects of the rules of the game that explain their non-transparency. These unwritten rules include the merger of formal and informal principles, implying the opportunistic and manipulative use of formal constraints and legislation, and the possibility of building corporate strategies on such a basis. What has so far remained unexamined is how the rules of the game are enforced, and how their enforcement itself contributes to the non-transparency of Russian economy.

Making enforcement transparent

To understand why unwritten rules are so crucial in matters of enforcement, let us begin with a basic scenario – involving an insolvency case – that illustrates the operation of the Russian business environment.

Firm C is owed a substantial sum of money by Firm X, which cannot or will not pay its debt. Firm C initiates insolvency proceedings against Firm X in an Arbitration Court and has the largest claim among all of Firm X’s creditors. According to the January 8, 1998 law “On Insolvency”, the Arbitration Court must appoint an interim manager to oversee Firm X’s

affairs while the case is under review. The interim manager – who watches over Firm X's assets, monitors the actions of its management and oversees major transactions – is chosen from among qualified (licensed) managers nominated by Firm X's creditors. The appointment of an interim manager is a pivotal decision, yet one which is not transparent: the Arbitration Court is not obliged to accept the nomination of the main creditor (Firm C) and instead appoints an interim manager nominated by a creditor (Firm P) with a much smaller claim than Firm C.

The management of Firm C suspects that the provisions of the insolvency law are being deliberately manipulated – and that the appointed interim manager and Firm P are controlled by a competing enterprise with links to criminal structures. If the interim manager were to allow Firm X's assets to be stripped, for example, and Firm C were not to recover its claim, its already precarious financial standing could be ruined. What options does Firm C have to prevent this from happening?

There are few legal defences open to Firm C to prevent the predatory acquisition of Firm X and the loss of its claim. Once interim managers are appointed by the Arbitration Court, they are very difficult to change because the law does not contain any provisions for an appeal. Thus, the stage is set for unwritten rules. Among extra-legal options, representatives of Firm C might arrange to have the licence of the interim manager revoked, thereby disqualifying him or her legally from serving as an interim manager. Alternatively, they could threaten to release sensitive information about him or her, or about the relationship between Firm P and organised criminal groups, in an attempt to pressure him or her to step down. In particularly high-stakes cases, threats of physical violence could be employed. As a respondent once put it to me,

To bankrupt an enterprise is elementary, only these conflicts do not get settled in the court. And not at the *strelka* (informal negotiations) either. Big deals are under control of the *silovye* structures (coercive ministries). Also, much depends on the status of the parties. With a medium-sized bank, one can simply rely on consideration of the case and the comparability of the bribes. With a big bank, a phone call from above will make the arbitration court take the decision desired by the big bank. An enterprise can win

regional arbitration if the governor supports it. But to win over the district (*okrzhnoi*) and the Higher Arbitration Court is an entirely different story.

The extra-legal sanctions that are used to solve cases such as the one above come in diverse guises, but together they comprise a toolbox of techniques for use in enacting justice and enforcing order. The main types of extra-legal sanctions used by agents to enforce their will in the new Russian economy can be summarised as follows:

<i>Type</i>	<i>Action</i>	<i>Institution involved</i>
1. Provoking administrative actions	Arranging for raids, inspections and citations for administrative violations; arranging clashes between local/regional/federal levels of administrative control	Use of administrative institutions
2. Interference with legal procedures	Opening, suspending and closing cases and official investigations	Use of legal institutions, tax police, state security organs
3. Financial pressure	Freezing assets, demanding repayment of debts, raising the level of kickbacks, purchasing debts (as a prelude to applying financial pressure on the debtor)	Use of financial institutions
4. Interference in personnel issues	Forced resignations and fixed appointments; staff reorganisation	Use of personal blackmail & <i>kompromat</i> collected by private security services
5. Informational pressure	Using <i>kompromat</i>	Use of personal blackmail & media institutions
6. Violence and the threat of violence	Informal negotiations and violent attacks: contract killings, car bombings, attacks on businesses and property	Use of coercive institutions

Let us briefly consider each of these categories in more detail. In today's Russia, as in Soviet times, the ability to solve a problem hinges not so much on one's own capacity, as on the power of the network that one can mobilise. The first category encompasses a set of administrative interventions relying on links with official structures: the regional administration; the tax inspectorate and tax police; the fire department and departments of sanitation and public health and so on. It is possible to arrange for a firm's access to water, gas, electricity and sewers to be cut off by the regional authorities under the pretext of arrears. These techniques have been practised widely and remain among the most common ways of neutralising opponents.

A second area in which sanctions are employed is in influencing official investigations and judicial proceedings. By using connections in various federal and regional authorities, it is possible to arrange for a criminal case to be opened (or closed), for tax evasion charges to be pursued (or conveniently forgotten), and for law enforcement officials to continue an investigation (or to abandon it). Local police and militia can be persuaded to initiate cases against purported suspects by setting them up or planting falsified evidence. At a higher level, influence with judges and prosecutors can affect results in criminal and civil trials, and if unfavourable judgments are handed down there are ways to ensure that they are not enforced in practice. In an interview, former judge Sergei Pashin testifies:

Q: We hear a lot about political pressure put on judges. How does this work?

A: The mechanism is traditional – distributing favours and privileges. Let's say you are the chairman of a court, and you want to become a member of the Supreme Court. Are you going to refuse to take the advice of the chairman of the Supreme Court? No, you're not. Or for example, the mayor calls you up and says you're really in debt. But I'll pretend not to see it, he says, and, by the way, I have a libel case in your court tomorrow. For some reason, the mayor always wins.¹⁸

¹⁸ RFE/RL
Newswire, October
17, 2000

A third way to enforce desired outcomes is to secure changes in key personnel. This can mean forcing someone to resign through public or

private channels, or arranging for a staff reorganisation in order to ensure that loyal individuals occupy strategic positions (as in the Aeroflot case mentioned above).

These first three families of sanctions are similar, in the sense that they all involve the manipulation of formal laws, measures and procedures by individuals with personal links to those who wish to have the sanctions enacted. As a result of a bribe, a long-standing personal relationship or an exchange of favours, a public official or bureaucrat agrees to use the authority of his or her position in a way not intended by the written rules. Thus, formal procedures and formal justice are substituted by personalised versions that maintain the trappings of legality while the true intentions of the underlying law are subverted.

Financial pressures form a fourth type of sanctions. Here, there are extensive permutations, such as arranging for an opponent's shares or assets to be frozen, refusing to renew the terms of a loan and demanding immediate repayment, threatening a firm with insolvency proceedings, and increasing the level of bribes and kickbacks demanded as part of a quasi-legal business deal.

If the first four categories of sanctions rely heavily upon administrative and economic methods to get things done, a fifth type is based on the use of information, especially blackmail files (*kompromat*), as a source of pressure.

Under the sixth category, we find a full spectrum of actions ranging from subtle threats of violence (offering a public official the choice between a bribe and a bullet), through violent encounters (physical shakedowns, beatings and the roughing-up of potential witnesses or opponents), to violent attacks and contract killings.

***Tolkachi* of the new Russian economy**

Our discussion of unwritten rules would be incomplete without a mention of the agents enforcing them. In the context of sanctions, these agents can be called the *tolkachi* ("pushers") of the new Russian economy. Under the Soviet system, *tolkachi*'s responsibilities were essentially to "close the gaps" in the planned economy that made it impossible for enterprises to meet production targets. In practice, this meant manipulating the

centralised system of allocation in order to procure resources needed to fulfil monthly plans, or manoeuvring within the bureaucracy to get targeted outputs reduced. Modern-day *tolkachi* compensate for the deficiencies in the market system by assuming functions that the state and newly installed market institutions cannot deliver. Like their predecessors, today's *tolkachi* are also forced to manipulate and violate the existing rules of the game in order to get things done.

Who are the *tolkachi* of today's Russia? The *tolkach* is no longer embodied in a single individual; such functions are now carried out either by whole departments within enterprises (private security services) or by private protection companies. Some of the security services in large industrial enterprises and FIGs can rival in size the security apparatus of a medium-sized country.

Gazprom, for example, employs 20,000 people in its security system, including 500 people in its central staff, and thousands more working

¹⁹ *Nezavisimaya Gazeta*, February 6, 1997

²⁰ For a more detailed account of the protection business in Russia see V Volkov, "Violent entrepreneurship in post-communist Russia", *Europe-Asia Studies*, 51:5 (July), 1999; and "Between the economy and the state: private security and rule enforcement in Russia", *Politics and Society* 28:4, December 2000

across the country at its subsidiaries.¹⁹ Private security services at large banks and enterprises are often headed by former high-ranking officers of the KGB and its successor organisations. The head of security at Stolichnyi Bank is a former commander of the specialised Alpha unit, while former KGB deputy chief Filip Bobkov is in charge of security at the Most group. By the end of 1999, there were 4,612 security services of this type in Russia.

Private protection companies make up the second category of security agencies.²⁰ These firms, which numbered more than 6,700 by the end of 1999, provide clients with protection and enforcement services. Like the internal security services, private security firms have often been founded by former high-ranking officers, or groups of individuals from security backgrounds who believe they can market their expertise to clients. Other firms developed into formalised businesses after beginning as informal security providers for specific commercial deals.

Thus, if taken at face value, the private security industry in Russia – as in other societies – appears to perform a relatively standard set of tasks, aimed at protecting the rights and interests of clients in

market transactions and in interactions with state representatives. This would certainly be the case if there was a fully functioning legal and market framework. Unfortunately, that is not yet the case in Russia.

Companies are compelled to secure a *krysha* (“roof”) – which as a rule means payment to either a private security firm or an organised criminal group – and often to give bribes to public officials (tax officers, health inspectors, bureaucrats who grant licences and so on) in order to get routine business tasks accomplished. Transaction costs that are connected to pervasive corruption and a high-risk environment may undermine the solvency of small firms in competitive markets. Small enterprises are vulnerable to extortion by bureaucrats (“administrative corruption”) and generally unable to secure favourable conditions for their business through private payments to public decision-makers (“state capture”).²¹

The disparity between how a market economy is supposed to work and the actual environment means that, in practice, Russia’s private security agencies – among other enforcers – fulfil a much broader set of functions than those that are enshrined in law. They tend to go beyond a narrow definition of their functions in guaranteeing the interests of client firms, facilitating their business transactions and enabling them to survive in the “market” environment. Their operations may stretch their lawful role or fall outside the legal framework altogether. In the 1990s, the list of characteristic functions performed by Russian security services included at least the following:

- 1 *Use and threat of physical violence.* Russian business in the 1990s became synonymous with burly bodyguards, detachments of camouflaged security officers armed with automatic pistols and submachine guns, motorcades of armoured vehicles, and heavily guarded “fortresses” that serve as company headquarters. These outward trappings of private security are used to project an image of strength, violence and inviolability. Yet private security forces are not purely symbolic: their representatives are directly involved in making and assessing threats and in conducting violent shakedowns (*razborki*)

²¹ See J Hellman, G Jones and D Kaufmann, “Beyond the ‘grabbing hand’ of government in transition: facing up to ‘state capture’ by the corporate sector,” *Transition*, April 2000. The authors distinguish between two forms of corruption: “Administrative corruption” refers to the conventional idea of corruption as payments required by public officials from private firms or individuals for the implementation of existing laws and policies. “State capture,” by contrast, describes the “capacity to affect the formation of the basic rules of the game (laws, rules, decrees, regulations) through private payments to public officials”

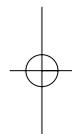
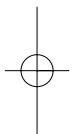
against opponents. They are also the enterprise's interface with the criminal world, serving for example as bridges to criminal culture and criminal slang.

- 2 *Intelligence gathering.* Security services at many Russian companies have sophisticated intelligence-gathering capacities. These are used for official functions, but also in the gathering of *kompromat* about current or potential competitors, civil servants and elected officials. Such intelligence is useful when it becomes necessary to "clear up" an issue (*raz'yasnit' vopros*) or to bring about a desired outcome. Security services at large enterprises maintain detailed files, including copies of bank statements, currency transfers, business and real estate transactions, passports and official documents, and general correspondence. Although private security services do not have the right to eavesdrop as part of their investigative operations, phone-tapping is common, as are other forms of surveillance such as stakeouts, shadowing and videotaping.
- 3 *Dispute settlement.* Security services are frequently involved in resolving conflicts of interest between firms, or between a firm and criminal structures. These conflicts are varied in nature, and may include disputes over property ownership, the control of an enterprise's board of directors or arrangements for settling a firm's debts. These settlement processes fall outside the formal framework of the law (even if the actual settlement takes place in court) and depend upon various powers of persuasion, including *kompromat*, direct or implied threats of violence, and informal sanctions.
- 4 *Negotiation with state authorities.* Specialised subdivisions of security services employ individuals who are skilled at navigating Russia's complex financial and legal spheres. These "facilitators" have detailed knowledge of legal frameworks – including the tax code, licensing requirements, and accounting and banking procedures – and the know-how needed to manipulate these codes to the firm's advantage. Such departments are capable of neutralising or circumventing aggressive bureaucrats, and may develop personalised links with elected officials and civil servants who can be called upon for favours in times of need. Using these informal negotiation techniques, security agencies can often orchestrate interventions by

local or regional authorities (in the media, in the Duma, by law enforcement organs or through administrative mechanisms) in defence of the enterprise or against opponents.

Rather than restricting their activities to “traditional” tasks (such as physical protection and the guarding of confidential materials), private security services have become the *de facto* administrative force of the economy: their activities enable Russia’s imperfect institutional framework to operate. Representatives of security agencies facilitate interaction with both state organs and other economic agents, including business competitors, organised criminal groups and other protection agencies. They turn certain elements of the law to their clients’ advantage, while deftly manoeuvring around legal and bureaucratic obstacles that block their progress. Security services are pivotal in both shaping agreements and in enforcing them – often in ways that disregard or undercut official institutions.

The role of security agencies in “solving problems” and enforcing outcomes is both driven by and a contributing factor to the chronic weakness of the rule of law. Given the state’s inability to perform its traditional functions (regulation of competition, enforcement of legal agreements, supervision of financial deals and property relations and so on), private security agencies have filled the void and become the arbiters of justice and the guardians of Russia’s unwritten order.



5 How can Russia's unwritten rules be changed?

Over the past decade, the Russian economy has been the site of a massive tug-of-war over the rules of the game. Western aid programmes have supported ambitious macroeconomic reforms aimed at “shocking” Russia into a functioning market economy. Foreign investors have attempted to introduce and apply Western business practices and norms to Russia. Such efforts have had only limited effect, however, because they have been subverted by existing informal codes. As the examples above demonstrate, the Russian economy remains far from transparent. The battle between past legacies and forward-looking market legislation is still underway – fuelling demand for unwritten rules and reinforcing their importance.

Despite overall acceptance of the informal order, it is important to note that there have been increasingly frequent and prominent public calls for a change in the rules of the game. Indeed, the concept of the “rules of the game” has entered into public discourse within Russia, as well as in the West, as part of the reform lexicon. At Davos in 1999, Prime Minister Yevgenii Primakov announced the government's intention to “make the rules of the game in Russia transparent”. International organisations have underscored that if Russia is to succeed economically in the context of globalisation and the information revolution, issues of transparency in the economy need to be addressed. Putin has repeatedly pledged to subject Russia to a “dictatorship of law”, and representatives of his administration have insisted that the government is serious about promoting order, stability and transparency within the economy. This idea was personally conveyed to the “oligarchs” by the president at a July 2000 meeting in the Kremlin, and again at a meeting with businesspeople on January 24, 2001.

Calls by smaller entrepreneurs for transparency are somewhat more credible than those of the state, because of the risks to business posed by

non-transparency. On the surface at least, demands for anti-corruption legislation, improvements in corporate governance, increased public participation in decision-making and more accountability indicate that, after a decade of “asset grabbing”, Russians desire the rule of law. However, one must be careful in evaluating these public exhortations for change in the “rules of the game”. Despite Putin’s calls for a “dictatorship of law”, the Russian state has an interest in maintaining a degree of non-transparency, since this bolsters the position of the *apparatus*. As Edward Keenan’s analysis reveals, unwritten rules have always been a powerful invisible hand within Russian political culture, and their presence is unlikely to melt away.

Does the experience of the past decade mean that Russia will be incapable of breaking free from the interdependence between the rules of the game and the unwritten rules that underpin them? Of course not. What it does show, however, is that in order to overrule unwritten rules, it is simply not enough to transform the formal rules and the ways they are enforced. Changes in the formal framework constitute a necessary but not sufficient condition. It is crucial to influence the system of informal constraints and their enforcement, including the unwritten rules which subvert, redefine and enforce the formal rules. How can this be achieved? Let us start by clarifying the obstacles on the way to changing unwritten rules in Russia.

Obstacles to changing Russia’s unwritten rules

To be sure, there are numerous obstacles that stand in the way of breaking out of the informal order of things and routine practices. On the surface, there is the effect of inertia, which results either from an insufficient will to change the state of affairs or the cumulation of contradictory actions, as expressed in phrases such as “everyone is “pro”, but nothing happens” (*use “za”, a delo ne idet*) or its reverse “all are “contra”, but nothing happens” (*use “protiv”, a delo ne idet*). Across the political spectrum, there is general agreement over the need for anti-corruption legislation, regulations on lobbying, laws on political parties, laws on governance and a land code. Yet nothing substantial has occurred to date, nor is it likely to, because of the problems with monitoring, control and other implications of such legislation. This inertia raises basic questions about the possibility of changing the informal order of things:

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- ★ Who is to fight corruption in a corrupt society, in which supposedly there is no individual or institution free of it?
- ★ How can one overcome resistance if the forms of resistance in question are, at the same time, the forms of survival?
- ★ How can the informal economy be eradicated in a system which cannot function without it?

In general terms, to demand fundamental change under such circumstances is to ask everybody to cut off the branches they are sitting on. The obstacles to such change can be found at every level of analysis: individual or group, network or societal. What can be done to overcome these obstacles?

First, fundamental change requires (or follows) radical shifts in the nature of social forces, such as:

- ★ a massive cultural shift within the population, and a related change in patterns of everyday life in Russia (to do with access to information technology, for example);
- ★ the emergence of a new social base, constructed around interest groups, that could break free from the current system (the absence of such a base is a reflection of the general weakness of Russia's fledgling civil society); and
- ★ a political will through which the institutions of power (the state and the bureaucracy), which are currently dependent on unwritten rules for exercising and maintaining power, are compelled to conduct policies that are designed to clean themselves and increase accountability.

All three types of shift would undermine the status quo for many social groups and require a long-term effort rather than a quick fix.

Second, the achievement of fundamental change requires the identification of the sources of resistance. I would argue that Russia's vibrant network culture serves to blunt, or dissolve, any pointed efforts at reform, because

of its compensatory functions. As in most societies, personal networks within Russia's economy perform dozens of functions, including those of redistribution, survival (food, money, mutual help), security, business, rent-seeking and so on. The problem is that Russian networks are overwhelmingly personalised and, as such, are distrustful of forms of de-personalised exchange involving organisations, contracts and distance. Because all levels of society operate according to the network principle, it is difficult to generate significant targeted reforms within any sector or constituency. The logic of unwritten rules is one dominated by personal interest, or by the interests of the network (the "people of the circle" – *svoi*), both completely divorced from the interests of the economy or society as a whole. The protection of one's own narrow interests, or the interests of one's network, almost always takes precedence over wider interests or the generic principles of economic rationality. This logic is maintained in Russia to an absurd degree.

Third, fundamental change requires the redistribution of functions formerly performed by the informal institutions (the rules of the game should be viable without unwritten rules). The main reason why it is so difficult to get rid of unwritten rules in Russia is that they serve an economic function. They perform the function of "shock-absorbers" for the system – always in flux and context-bound, they adjust and readjust past-oriented informal codes and newly built formal ones. They also help to bridge the gap between these codes and their enforcement. They serve to solve the problems posed by the formal framework, and compensate for the deficiencies of Russia's political culture and legal system.

If Russia's unwritten rules are to be changed, a whole set of functions performed by informal institutions and predicated upon those rules will need to be dealt with. In other words, the problem is not the existence of informal practices or institutions per se, but their indispensability for bridging the gaps in the formal framework. When or if some of these informal institutions are rendered ineffective or unnecessary, they will disappear. No doubt, this is a very long-term process. The belief behind this analysis is that an attempt to reform unwritten rules could speed it up. I suggest that improvements to the formal framework should be considered in conjunction with the reduction of the role of unwritten rules in the system.

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What can be done to change the unwritten order?

In theory, the significance of unwritten rules can be reduced in three ways:

- ★ First, the rules of the game and the principles of their enforcement have to be made clear for all those involved in business, so that economic success is no longer dependent on mastery of the unwritten rules. That is to say, the formal and informal rules have to be observable and enforceable on their own, and the spheres regulated by the formal and informal rules have to be separated. *²² Some measures to counteract these tendencies are starting to be taken under the Putin administration. According to First Deputy Prosecutor-General Yuri Biryukov, approximately 18,000 officials were charged with economic crimes last year, including more than 1,000 Interior Ministry officials, 120 customs officials, more than 20 tax police officials, 30 judges, and 10 prosecutors (ITAR-TASS, quoted in RFE/RL Newswire 5:30, Part 1, February 13, 2001)*
- ★ Second, the selective nature of enforcement has to be acknowledged as unavoidable, exposed and dealt with on a long-term basis. A disinterested state is a prerequisite of such change. So far, state institutions have been too closely involved with business and interest groups.²²
- ★ Third, the significance of unwritten rules can be reduced through the better accommodation of different sets of interests. In other words, a “zero-sum game” mentality should give way to an understanding that success at one level does not necessarily mean failure at another. For example, Russia’s entrepreneurs could be made to operate in a more socially productive manner, while the regional and the federal levels of the economy could be coordinated better.

In an economy the size of Russia, these suggestions may sound unworkable, but they constitute an important set of criteria for measuring fundamental change. On a practical level, one should remember that excellent reform programmes have already been produced which, for various reasons, failed to achieve their targets. A perfect example of such a reform might be the revised tax code approved by the Duma earlier this year. The mythology of the previous tax code was that revenue collection was low because business was being strangled by an extortionate tax burden. Following this logic, reducing the tax rates should result in higher tax revenues. In fact, this assumption may not prove entirely correct, since paying taxes in Russia is subject to unwritten rules. The latter are bound to distort the effects of formal legislation. Thus, the implementation

of the new tax code in 2001 is an excellent test for the actual impact of Russia's unwritten rules. At worst, we will not see any significant change in the process of taxation. At best, the new tax code will influence the dispositions of those involved in tax bargaining in an economically beneficial manner.

When making changes to the formal rules, it is important to think at the same time of alternatives to top-down reforms. The reform of the formal framework has to be supplemented by invoking processes at a grassroots level, creating prospects for spontaneous change from below and bringing about an eventual decline in the significance of unwritten rules. It would help if those involved in the reform process – whether Russians or outsiders – bore in mind the following principles:

- 1 The *formal constraints* notoriously associated with extra-legal practices have to be identified and revised, as was done with the tax code. Equally important, non-functioning legislation has to be identified and abolished. A long-term commitment to the impartial enforcement of the revised formal constraints must be in place. The establishment of channels for bottom-up feedback on these formal rules and their enforcement may help to minimise the need for informality in the system. Otherwise legislation will remain ineffectual, regardless of efforts at reform.
- 2 The *informal constraints* tied up with the legacies of the command system and traditional patterns such as patronage should be targeted. This can be done by encouraging public debate on the role of informal constraints, demonstrating how the rule of law is a more advanced form of social contract and so on. Such a campaign might involve openly spelling out the legacies of the Soviet era and explicitly acknowledging their continuing significance. The financing of opinion polls, research, educational literature, relevant television programmes and popular advertising would help to bring about an awareness of unwritten rules.
- 3 A framework needs to be set out to enhance the professionalism of *social actors* and good management at every level. People in Russia have an enormous potential for ingenuity, which is now “wasted” on outwitting the system. This potential could be a source of positive

change if synchronised with the interests of the economy as a whole. The growing demand for the rule of law among entrepreneurs suggests that, in certain sectors at least, there is a desire for behaviour and standards that diverge from previous norms. Long-term efforts are required to introduce the standards of professionalism and management that would help to replace the informal order of things. Training programmes for managers of different levels are essential to such efforts.

4 The modernisation of *social networks* could reverse their role as an impediment to the economy. Instead of subverting the economy's dominant functions and processes, social networks can help organise and facilitate them. Civil society initiatives could aim to foster the creation of new networks, while existing networks should be made more open and inclusive. Professional networks have to cease being personalised, closed up and based on the exploitation of workplaces. In order to examine specific ways of transforming social networks, one needs to look in more detail into the conditions that generated their undesirable features.

5 Finally, *outside influences* and organisations can play a substantial role in transforming the setting for the unwritten rules. On a company level, investors, lawyers and consultants can act as "role models", introducing new practices and norms into the Russian economy. However, this transfer of standards has not so far proceeded as hoped for, and most Russian businesspeople are convinced that their western counterparts operate as the Russians do. Indeed, according to one western lawyer, the behaviour of western firms in Russia is not identical to their behaviour at home, mainly due to widespread stereotypes, such as: (a) Russia is another planet, no rules apply; (b) there is no law in Russia; (c) one cannot enforce one's contractual rights; (d) one never wins in Russian courts; (e) one cannot do business in Russia if unprepared to give bribes.

²³ For example, see "The smell test: Western financiers hold their noses when they do business in Russia", *The Economist*, February 24 2001

Although these stereotypes might not be totally untrue, it is regrettable that business ethics and international standards have become compromised. According to the *Economist*, the world's top financial companies and accountancy firms are implicated in various

controversial affairs in Russia.²³ On the other hand, a lack of flexibility towards the Russian business environment on the part of outsiders, and their refusal to become adept at using unwritten rules can result in intense frustration, financial losses and even personal harm.

It remains to be studied when and under which circumstances political players might collaborate to demand, and economic players might support, substantial state action to promote improvements to the investment climate. However, it is clear that investment dilemmas cannot be resolved by investors single-handedly. The creation of an investment climate in which such dilemmas do not arise is a matter of internal political will and effort. Pressures from both the international business community and multilateral institutions (such as the IMF, the OECD and the EBRD) for the diffusion of international accounting standards or the adoption of good corporate governance practices are necessary, but far from sufficient factors.

Unfortunately, even with the best intentions, reforms that are designed to improve the investment climate might still be hampered by unwritten rules, some of which are “protective” of the domestic market from “foreign intervention” or open competition. The involvement of EU legal experts and law firms in the resolution of conflicts in European commercial courts, and advice on issues of “protectionism”, could help to close the standards gap between Russia and the OECD countries.

6 Conclusion

The transformation of unwritten rules is an essential precondition for a fundamental and positive change in the workings of the Russian economy, and this has to be addressed in a direct fashion.

The alternative vision suggested by the principles outlined above does not mean that we need yet another programme to be conducted by yet another institution. Rather, it offers new dimensions of “grassroots” thinking that could become part of any programme; this new approach could be incorporated into the implementation of reforms that are already being conducted by the government, state institutions, NGOs, the media, educational agencies, various social and economic bodies, and foreign aid donors.

It is difficult to say much more about how the potential of such an alternative vision can be exploited, without going into the details of particular examples. In any case, further research is needed to provide more empirical data on unwritten rules, and to explore their functions and implications in more detail.

There needs to be research on whether President Putin’s efforts to install “new rules and order”, along with his attempted de-bureaucratisation of the economy, have been effective in improving the nature of the unwritten rules. Some economists argue that to a certain extent, tax evasion or other forms of waiving the formal rules are generally helpful to an economy: they may allow small companies to operate more efficiently. It is crucial to analyse to what extent this is indeed the case in Russia.

In this respect, it is no less important to establish which formal rules are currently the wrong rules, and which are the right rules that for various reasons cannot be enforced. In the former case, unwritten rules are likely to be necessary and efficiency-enhancing in some sense. In the latter case they are efficiency-reducing: enforcement cannot take place because the

interest groups which benefit from the prevalence of unwritten rules are too powerful. The ambiguous nature of unwritten rules implies that both categories of formal rules co-exist, and further research will need to distinguish between them.

The informal constraints also need further exploration. One should concentrate on the extent to which, or circumstances under which, Russians may safely transgress the formal rules; or, indeed, on the issue of who may safely transgress such rules. Take tax evasion, for example. The informal rules of the tax game imply a considerable tolerance of arrears on the part of the authorities, but this tolerance is not unlimited or extended equally to all players. Otherwise, no one would pay anything. Hence, to understand the unwritten rules of the tax game, we need to know more about the things that determine the authorities' willingness to be flexible.

This will, of course, include personal connections and bribes, but it will also touch on such issues as economic circumstances (the oil companies get squeezed when the oil price rises), the socio-economic importance of an enterprise to a given region, whether taxes are federal or regional (and who is collecting them), and so on. It is possible to get a feeling for the way different individuals or companies find a balance between evasion and compliance. The same may be said of capital flight, share dilutions, asset-stripping and other such practices. More empirical data will tell us more about the unwritten rules at work in these domains.

The issue of how to measure the effect of unwritten rules on the economy is another important subject for future analysis. It would be a challenge to elaborate some indicators that would allow one to track changes over time in the importance of the unwritten rules. One possible proxy measure could be the division of Russian gross business profit between tax, capital flight and domestic investment, as it evolves over time. Alternatively, the price of the unwritten rules could be estimated as a share of transaction costs in the Russian economy (some such studies already exist). The price could also be assessed in terms of the cost to social welfare, growth, investment, transparency and the like.

Meaningful data on the dynamics of unwritten rules in the post-Soviet economy would help to answer one longstanding question: whether the

prevalence of unwritten rules is a feature of Russia's persistent political culture, or a transitory economic function that fills the "institutional vacuum" created by radical socio-economic reforms. To estimate the extent to which both are true would help to create a point of reference for aid packages, and to establish which groups might be the best recipients for such aid. The fact that it may be hard to target institutional weaknesses directly through foreign aid programmes should not deter donor organisations from trying to push ahead on the basis of the above-mentioned proposals.

The experience of the past decade has shown that foreign aid to Russia has suffered from the same processes of diversion and distorted distribution as other resources within the economy. This diversion can occur at many different levels, whether in the "closed" local networks that are based on patronage or clan-like relations, or in those of international institutions that are characterised by secrecy, lack of debate and favouritism.

Among other factors that can contribute to the diversion of aid are programmes for which the funds are not clearly targeted, aid packages which lack clear objectives and stages of implementation, and the direct personal involvement of one particular group or clan to the exclusion of others. It is therefore crucial to ensure that:

- ★ aid programmes are developed on the basis of pilot research, open debate and democratic procedures, and that they are made transparent;
- ★ successful aid programmes are carefully analysed, so that lessons can be learned from the experience;
- ★ aid programmes are not based on the "top-down" implementation pattern;
- ★ the managers of aid programmes follow the principles that they themselves preach, and they should ensure that aid recipients do the same;
- ★ aid programmes help to popularise and promote the donor, defining its identity in the regions of Russia, and thus enhancing support for the aid objectives from below.



To minimise the misuse of aid, foreign donors should acknowledge the potency of unwritten rules in sustaining the non-transparent “rules of the game” in Russia, and structure their aid initiatives accordingly.

