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**THE SHAKEDOWN STATE**

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Настоящая работа посвящена особенностям взаимодействия власти и бизнеса в посткоммунистической России. Автор демонстрирует каким образом представители бюрократического аппарата осуществляют давление и устанавливают контроль над малым бизнесом, тем самым способствуя его тенефикации. Е.М. Альбац утверждает, что поведение бюрократии совершенно рационально и обусловлено личными интересами ее представителей и принятыми правилами административного порядка в современной России.

Представляемый текст является сокращенным вариантом главы монографии, которая в настоящее время готовится к публикации: Bureaucrats and the Russian Transition: The Politics of accommodation, 1991—2003 (Бюрократия и российская трансформация. Политика приспособления, 1991—2003).

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**Albats E.M.** The Shakedown State: Working paper WP4/2005/01. — Moscow: State University — Higher School of Economics, 2005. — 40 p. (in Russian).

The paper “The Shakedown State” is devoted to studying the relationship between bureaucrats and small business in the Post Soviet Russia. The author shows the ways in which bureaucrats exercise pressure and impose control over small business, pushing them down into the shadow economy. E. Albats argues that they behave in a very rational manner, in accordance with their interests, and the rules of the game that exists in the current Russian state administration.

The paper is a short version of the author’s chapter of the book “Bureaucrats and the Russian Transition: The Politics of accommodation, 1991—2003” that is getting published.

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## 1. Imagine, you decide to start a small business in Moscow<sup>1, 2</sup>

Imagine that this business is a downtown restaurant in the busy political and business part of the city with lots of people that would love to spend money there, for lunch and dinner. Given that Moscow is roughly the size of New York but has only one-tenth of the number of restaurants (Chernov, 2003),<sup>3</sup> you might expect your start-up to find a market. Given that Russian consumers tend to spend almost half of what they make on food, you might consider that type of small business to be a smart investment as well (Table 1).<sup>4</sup> You might even expect city authorities to be happy about it: greater competition means lower prices, more customers, and thus, more tax revenue in the city coffers, right? <sup>5</sup> Wrong.

**Table 1.** *Consumer Spending in Russia and the Czech Republic in 2001, %*

	Russia	Czech Republic
Total spending	100	100
Obligatory payments and non-consumer spending	10,5	22,3
Food	45,6	20,5
Non-food products	30,8	29,9
Utilities and housing	4,6	14,2
Transportation	2,2	1,5
Communication Services	1,1	2,2

Source: Interactive Research Group: *Russian Economic Overview, 2002.*

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<sup>2</sup> © Albats Yevgenia Mark, United States Copyright Service, № TX5-937-349. Оригинальное название главы: *The Shakedown State*. Данный текст является сокращенным вариантом главы монографии, которая в настоящее время готовится к публикации: *Bureaucrats and the Russian Transition: The Politics of accommodation, 1991—2003 (Бюрократия и российская трансформация. Политика приспособления, 1991—2003)*, защищенной в качестве докторской диссертации в Гарвардском университете в 2004 г. Использование данных возможно только по согласованию с автором. Все права копирайта защищены.

<sup>3</sup> Sergei Chernov, *Restorannii Rating. Putevoditel' po Restoranam* (Moscow, 2003).

<sup>4</sup> Rosinter Restaurants, part of Rostic Group, has opened several restaurants in Russia, the CIS and Europe. The company claims that the average payback period for one restaurant with 250 square meters of trade area and an initial investment of \$300,000 is 2—2,5 years, which represents a very high return. *Russian Economic Overview* (IRG, 2002): 228.

<sup>5</sup> According to observers of the restaurant business, this market has had a tendency for steady growth at a pace

In this chapter, I will show the ways and means by which bureaucrats exercise pressure and impose control over small business, pushing them underground into the grey economy. I will argue that there is a logic in how bureaucrats treat small business, which in turn derives out of incentives to stay in the state administration. Bureaucrats are not opposed reforms in general; on the contrary, in the initial stages of reform, the interests of the reformers and bureaucrats closely coincided. However, further in the transition, their interests require getting control over the nation's economy — even at the expense of sacrificing some rent-extraction opportunities: they do it so to safeguard their partial property rights. I argue that they behave in a very rational manner, in accordance with their interests and motivations, and in accordance with the rules of the game that exists in the current Russian state administration. They do nothing ad hoc, strange or unexpected: they behave in agreement with the experience they obtained in the Soviet era, when they felt safe and comfortable, and at the same time utilizing and accommodating some advantages of the new market environment.

...So, what should you expect to face if you decide to open a start-up business in Moscow?

A two-inch thick bound folder of official documents required to open a restaurant was presented to me by the owner (who will be known hence as *Maxim*) of a start-up restaurant. This folder consisted of twenty-eight different types of documents — deeds, titles, certificates, licenses, permits, resolutions, you name it — issued by agencies of the four different levels of authority (block, district, municipal, and federal) plus two law enforcement agencies, seven specialized agencies and five different hybrid institutions called GUP (*gosudarstvenniye unitarniye predpriyatiya*, the name given to semi-state semi-private organizations). Some agencies issue just one permit, some issue as many as six; some require many documents to obtain just one stamp of approval, and some require as many as six signatures from six different agencies of the three levels of authority (Table 2).

**Table 2.** *Agencies involved in granting approvals necessary to open a restaurant in Moscow (2001)*

Type of Agency		Managerial	Law Enforcement	Specialized	Hybrid (GUP)
<b>LEVEL of AUTHORITY</b>	<b>Federal</b>	Ministry of Economic Development, Trade Inspection	Ministry of the Interior, State Fire Authority	1. Ministry of Health, State Sanitation Inspection 2. State Statistical Agency	1. GUP, Center for the state sanitation-epidemiological authority

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	<b>Municipal</b>	1. Moscow City Government (Department of Consumer Services) 2. Moscow City Government Licensing Chamber	Moscow Tax Inspection	1. Moscow Energy Utility 2. Sanitation Inspection 3. Fire Inspection 4. Administrative-technical Inspection 5. Moscow Communal Buildings Project 6. Moscow Committee on Architecture 7. Directorate of Underground Communications	1. Moscow cash register production & control plant 2. Moscow Advertising Center 3. Directorate of Commercial Police 4. GUP "Moscow Committee on Architecture" 5. GUP "Enlakom"
	<b>Municipal</b>	1. Moscow City Government (Department of Consumer Services) 2. Moscow City Government Licensing Chamber	Moscow Tax Inspection	1. Moscow Energy Utility 2. Sanitation Inspection 3. Fire Inspection 4. Administrative-technical Inspection 5. Moscow Communal Buildings Project 6. Moscow Committee on Architecture 7. Directorate of Underground Communications	1. Moscow cash register production & control plant 2. Moscow Advertising Center 3. Directorate of Commercial Police 4. GUP "Moscow Committee on Architecture" 5. GUP "Enlakom"
	<b>District</b> <b>Block</b>	Office of the District Authority Office of the block authorities		District Sanitation Inspection  Department of Communal Services (garbage collection)	

of roughly 15% per quarter over the last couple of years. Its potential is estimated at \$150–200 million.

Following is a list of signed documents that must be obtained by a prospective restaurant owner:

**Figure 1.** *Required Documents to Open A Restaurant in Moscow*

**A. Safety issues:**

1. Report on the safety of electrical wiring in the building (Moscow Energy Utility).
2. Conclusion on the state of fire safety in the building (Ministry of the Interior, State Fire Authority).
3. Resolution on the state of security of the building [from possible burglary] (Directorate of Commercial Police).

**B. Sanitation Issues:**

4. Deed of pest extermination and overall hygiene (District Sanitary Inspection).
5. Resolution on meeting the conditions to put business into operation (Municipal Sanitary Inspection).
6. Deed on sanitation-epidemiological expertise (District Sanitary Inspection).
7. Sanitation-epidemiological conclusion on "compliance the rules and norms of sanitation to protect public health (GUP, Center for the state sanitation-epidemiological authority).
8. Conclusion on the state of ventilation (District Sanitation Inspection).

**C. Zoning Requirements:**

9. Permission to open a restaurant in an apartment building (Moscow Communal Building Project).
10. Conclusion regarding the appropriateness of the interior of the business (District Sanitation Inspection).
11. Lease or title of property ownership (Office of the District Authority).
12. Conclusion regarding the street appearance of the business (Moscow Committee on Architecture).
13. Certificate of permission to place advertising [such as a signboard] (GUP, Moscow Advertising Center).
14. Colorist title (GUP, "Moscow Committee on Architecture")
15. Confirmation of the establishment of a signboard (GUP, Moscow Advertising Center).
16. Passport on materials used in the building (Artist at Large, GUP "Enlakom" of the Moscow Committee on Architecture).

**D. Everyday Operation Issues:**

17. Conclusion on the validity of the official seal on the cash register (GUP, Moscow cash register & control plant).
18. License for conducting restaurant operations (Office of the District Authority).
19. Certificate of compliance [with norms] (Moscow City Government, Department of Consumer Services).
20. Deed of acceptance [of the business] (a) Ministry of the Interior, State Fire Authority; (b) Ministry of Health, State Sanitation Inspection; (c) GUP, Moscow Advertising Center; (d) Office of the District Authority; (e) Office of the block authorities; (f) Moscow Administrative-technical Inspection.
21. License to sell alcohol products (Moscow City Government, Licensing Chamber).
22. Confirmation of tax status (Moscow Tax Service).
23. Agreement for garbage collection (Block authority's Department of Communal Services).
24. Approval of menu (*assortimentniy maximum*) (Doctor at Large, Office of the District Authority).

**E. Other:**

25. Confirmation of having submitted statistical information & obtained statistical codes (State Statistical Agency).

As may be inferred from the list, the purpose of this multitude of documents is to ensure: (a) compliance by a prospective business with norms and regulations, (b) protection of consumers and (c) control over everyday operations. There is certain logic to the types of agencies involved. Specialized state agencies as well as hybrid agencies (GUP) serve to provide expertise on proper compliance with rules and norms, be it the safety of the electrical wiring or merely the business's street-side appearance. Managerial offices grant permission to open and conduct business based on expertise provided by the specialized and hybrid agencies. Finally, the law enforcement agencies as well as the control departments of particular agencies (such as the Trade Inspection Agency) oversee the proper conduct of business on an everyday legal basis.

As they say, however, the devil is in the details. First, there is the overlap of functions among the various levels of authority and the various types of agencies. For instance, confirmation of compliance with sanitation rules requires five different deeds and resolutions that are issued by state agencies of two levels of authority and two types of agencies. One might argue that when it comes to protecting consumers from food infected with deadly viruses, no control is too great.<sup>6</sup> However, a similar pattern is seen regarding other issues. For instance, concerning zoning laws, the street appearance of a restaurant requires permission from the municipal Committee on Architecture as well as its commercial counterpart, or GUP. "It is all about money: you pay [fees plus bribes] in both places even though both oversee the same issues; and the one [GUP] is just a commercial branch of another [bureaucratic agency]" *Maxim* explained.

Furthermore, the rules and norms imposed by bureaucrats are so detailed and strict that it is nearly impossible to comply with them. For instance, the Colorist Title of the building states the precise tone of the color. In the case of *Maxim's* restaurant, it was pink. However, pink has several hundred different tones. Thus, the Colorist Title states the precise tint of pink that *Maxim* must maintain unless he applies for a new Colorist Title. Also, the details stated in the permits are so precise that they allow for endless and unlimited control by bureaucrats. Any new dish added to the certified menu requires permission from the Doctor-at-Large of the District Office Authority. A deviation in the size and weight of the meal may incur penalties. "The everyday pain is finding hens of the same size and weight. Should the Trade Inspection officer come and find that one portion is 200 grams and another is 230 grams, we must pay penalties. It is even harder with fish; but requirements are such that, for example, each trout must be of the same weight" the owner complained. One might think that consumers are capable of judging

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<sup>6</sup> Obviously, I allude here to the public interest theory of regulation, which argues that a government protects public against self-interested markets by imposing such a system of screening, which precludes market failures and ensures consumers' rights to buy high quality products and services. Simeon Djankov et al. in *Regulation on Entry* (2001) convincingly argue against such an approach.

the quality of food and service no worse than the Trade Inspection judges. But apparently they are not trusted for such a responsibility. It is easy to understand why: leaving it to consumers means depriving bureaucrats of the ability to extract rents. As it was noted before, 61% of gains accrued by many various bureaucratic agencies comes from giving expert resolutions of the kind outlined above.<sup>7</sup> Generally, the “under the table” price of opening a restaurant in Moscow is *thirty* times higher than the official price. Whereas the complete set of necessary fees and stamps officially amounts to \$300—500, the same set of required documents obtained via a middle-man (e.g., a company that works the bureaucracy and finds the right people to accept the right bribes) costs between \$15,000—20,000 (the price paid by *Maxim*). Still, this is not the end of the story. All the documents specified on the list expire after one to three years. “Access to a high-top *nachalnik* (official) (sure, it won’t be free), but it will help to get the permits for three years. If you lack such access, you are stuck going through the whole process every year” said the owner (who has had two other highly successful restaurants). Thus, whether the owner of a restaurant must renew his deeds, certificates, licenses and other permits every one, two or three years, depends on the type of connections he has. Given that bureaucrats possess endless tricks to extort rents — for instance, an office in the local tax agency, where a business is required to be registered, may be open for as little as ten minutes twice a week, as one empirical study revealed (Tambovtsev, 2001b)<sup>8</sup> — it is obviously easier to pay off a bureaucrat in authority rather than try to fulfill the requirements via legal means.

Of course, these hardships are not unique to the restaurant business. For instance, opening a small bakery requires permission from eight different agencies, twenty types of documents, at least 270 hours of dealing with the bureaucracy, and several hundred dollars in bribes. A small kiosk selling cigarettes and other miscellaneous items demands thirty-two stamps of approval and various other permissions. The list of documents necessary for a larger business—such as a family operation that makes sausages—consists of 105 various regulatory and permit documents (Auzan 2001).<sup>9</sup> On average, according to estimates, a start-up business in Moscow requires

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<sup>7</sup>Anastasia Onegina and Boris Grozovski, “Nastupleniye na Kontrolerov” (Attack on Controllers), *Vedomosti*, 3 February 2003.

<sup>8</sup>Vitali Tambovtsev (2001b), “Podchody k sovshenstvomvaniu sistemy regulirovaniya predprinimatelskoi deyatelnosti” (Ways for Perfecting the System of Regulation of Entrepreneurial Activities); Analytical report prepared for a meeting of the government of RF. Copied from the original. Part of that research can be found in: Vitali Tambovtsev, ed., *Economicheskii Analiz Normativnich aktov* ( Moscow: TEIS, 2001).

<sup>9</sup> Large, and even very large, businesses are not exempt from bureaucratic taxes. For instance, the Sakhalin Energy Investment Company Ltd. (Sakhalin Energy), a multi-billion dollar oil and gas consortium of subsidiaries of such giants as Shell, Mitsui and Mitsubishi, needed to acquire 1,117 permits over a three-year period at a cost of \$5 million (Auzan, 2001). Obviously, the difference between big



the solicitation of 20–30 various bureaucratic agencies, and as many as 50–90 approvals — or an intermediary, whose fee can be as little as \$400 or as much as \$20,000 and over (Tambovtsev, 2001b).

Nevertheless, let us imagine that you manage to secure enough capital and establish enough connections to open your restaurant — you have a great manager, a good cook and attractive decor to face the competition of the market. All of these good things are still, by no means, a guarantee of success, because success also depends on your relationship with bureaucrats from the various law enforcement and oversight agencies that supervise everyday operations. A report issued in 2003 by the Ministry of Economic Development and Trade outlined sixty-five different oversight bureaus in forty-three federal agencies. These bureaus employ 800,000 inspectors (in addition to police). To illustrate how meddlesome such a force can be, in the year 2000 each small business was inspected on average ninety times by police, twenty times by Sanitation Inspection, and four to ten times by other oversight agencies.<sup>10</sup> In the case of restaurants, police, trade, sanitation and tax inspectors are the most frequent extractors of rents — typically more than once per month (*Maxim* 2001). Police look for the presence of illegal labor and violations of liquor and cigarette codes, and trade inspectors review kitchen cleanliness and food safety, and by doing that they have ample ability to make trouble for the business if their terms are not met. Interviews with small business owners also reveal that pay-outs to criminal gangs, which collect their share of rents in exchange for protection from other gangs, is comparable or just slightly less than the fees extorted by bureaucratic agencies (Table 3).

**Table 3.** *Frequency of control visits to small businesses*

	Less than once a year	Annually	Each Quarter	Each Month	More than once a month	“Don’t remember”
Fire Authority	19,9	30,4	36,7	6,6	2,8	3,6
Sanitation Inspection	30,4	25,5	19,9	15,7	4,2	4,3
Registration Chamber	63,6	19,9	3,1	0,7	1,0	11,7
Licensing Chamber	55,6	24,5	7,0	2,1	1,7	9,1

business and a small business is that the former has enough cash for a down payment, whereas a small one does not.

<sup>10</sup> Onegina and Grozovski, 2003.

	Less than once a year	Annually	Each Quarter	Each Month	More than once a month	“Don’t remember”
Directorate of Architecture	70,6	10,1	3,5	1,4	0,7	13,7
Tax Inspection	15,4	30,4	27,6	8,4	14,0	4,2
Police	35,7	16,4	15,7	11,2	14,0	7,0
Customs	69,6	4,9	2,8	2,4	1,7	18,6
Pension Fund	43,4	28,3	15,4	4,2	1,7	7,0
Criminal Rackets	35,0	1,4	8,7	34,3	2,8	17,8

Source: Russian Independent Institute of Social & National Problems, 1999.

Criminal rackets use a clear-cut timetable for rent extraction: 34,3% of such gangs come less than once per month and 35% come less than once per year. For a business owner, such predictability allows time to budget for such expenses. Conversely, however, bureaucrats from the police, sanitation and tax inspection prefer more frequent and chaotic visits. Furthermore, criminal rackets at least provide protection from other similar groups, whereas bureaucratic agencies do not coordinate their visits between each other. Also, rackets extract commissions based on the volume and profitability of the particular business, whereas bureaucratic fees are based on 60,000 different regulatory documents (Tambovtsev, 2001a). A café owner in Ufa, a city in the provincial Russia, gives the following description of what life is like:

A sanitation inspector comes and says ‘here you need an additional dividing wall, and there you need something else, etc., or I am going to close down your café.’ Later, over a bottle of vodka, the inspector herself confesses that no one can and no one does comply with all those GOSTs [*gosudarstvenniye standarti*, or state standards]. Then, the fire inspector arrives, and he claims that the walls in my café are made out of the wrong materials. I tell him: ‘this café existed under the Soviet Union [hence, was owned by the state, which outlined those regulations]. Back then those walls were considered OK.’ I asked him right away: ‘How much do you want?’ He does not say, but claims, instead, that the lamps in the café also do not comply with standards... Once again: ‘I am going to close your café based on violations of the fire safety norms.’ You weep, you beg... Finally, he has a free dinner and a free drink with us, and he walks away. Everything now is

OK with the norms — until he or another inspector comes back (Klymkin and Timofeev, 2000).<sup>11</sup>

Consequently, this abundance of overlapping and contradictory norms and regulations makes dealing with the mafia and other illegal channels less chaotic, more predictable and generally more attractive to small business owners. “I find it cheaper to pay *krisha* in order to deal with all those controllers [who come to inspect the business]. At least the price of *kryshi* is well defined” the owner of a small pub in St. Petersburg told a reporter.<sup>12</sup> Recent research suggests that small businesses spend \$6 billion annually on bribes to bureaucrats, and the same amount as payments to various *krisha*, e.g., protection services performed both by mafia and by bureaucrats in epaulets (Shestoperov, 2003).<sup>13</sup> Another study, conducted in 61 regions of the Russian Federation by an association of small and mid-size businesses called *OPORA*, supports these claims: less than half (45%) of businesses questioned trust the legal system (i.e., the courts) as a means to defend their rights. Half ask for help from different “authoritative people” meaning protection services, lobbying groups, human rights groups. etc. (Borisov, 2003).<sup>14</sup> Even businesses that are eager to work within the legal framework — if only because bribes and protection services make everyday life far too risky — cannot do so: “Right from the beginning, when we opened our [family] business, we decided that we were going to be legal. We tried very hard, but four years later, we gave up, and hired an intermediary company to deal with the authorities. We were told: ‘Whether you want this or not, \$300 monthly cash is your fee just to the Office of the District.’ They said that if we didn’t pay, ‘you will not be able to work in our district,’” the owner of a family retail business from St. Petersburg told the researchers.<sup>15</sup> It is easy to see why they do not choose legal channels to defend their rights: a price tag is already attached to many decisions dealing with business disputes, be it for an investigation of the case or for a judicial hearing.

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<sup>11</sup> Igor Klymkin and Lev Timofeev, *Tenevaya Rossia (the Shadow Russia)*, Center on Study the Illegal Economic Activity (Moscow: Russian State Humanitarian University, 2000): 402–03.

<sup>12</sup> Onegina and Grozovski.

<sup>13</sup> Oleg Shestoperov, Head of the Institute of Systemic Research of Entrepreneurial Problems. Transcripts of a round-table discussion “Russian Small Business: Questions and Answers” Liberal Mission Fund, September 30, 2003. Available at: <http://www.liberal.ru/sitan.asp?Num=396>.

<sup>14</sup> Sergei Borisov, President of the All-Russian Organization of Small and Mid-size businesses “OPORA Rossii.” Transcripts of a round-table discussion “Russian Small Business: Questions and Answers” 2003. Ibid.

<sup>15</sup> Ella Poneych, “Pravila Igri: Sam Dolzhen Ponimat’s” (Rules of the Game: One Should Understand Them), *Vedomosti*, 18 November 2003.

**Table 4.** *Price of judicial favors (selected cases), \$*

Suspension of investigation	1,000
Release from custody	10,000—20,000
Dismissal of case	25,000—50,000
Arrest of the competitor accompanied by planting false evidence (usually heroin)	10,000—30,000
Victory in a case that is otherwise doomed	100,000

*Source: Coudert Brothers Law Firm, Yevgenia Albats, Global Access Project, 2003.*

So how does small businesses in general, and the restaurant business in particular, survive? To put it bluntly, rather badly. In 2001, ten years after the start of economic reform in Russia, the number of small businesses is roughly the same as it was in 1995, and has yet to reach the number that was registered in 1994 (see Table 5). In the following pages, I suggest that the poor performance of small business in Russia can be blamed directly on the control aspirations of bureaucrats.

**Table 5.** *Number of small businesses in Russia*

Year <sup>16</sup>	Small & mid-size businesses (thous.)	Number of people employed in small businesses (mill.)
1991	64,0	2,2
1992	560,0	8,6
1993	865,0	6,6
1994	896,9	8,5
1995	877,3	8,9
1996	841,7	6,3
1997	861,1	6,5
1998	868,0	6,2
1999	890,6	6,4
2000	890,6	6,6
2001	875,5	6,3

*Source: Goskomstat, Working Center of Economic Reform under the Government of the Russian Federation.*

<sup>16</sup> The break in the table between years 1995 and 1996 meant to address the problem that exists regarding coherence of statistics. From 1992—1995, small businesses were defined as those employing no more than 200 people (Executive Order of the Government of the Russian Federation, № 446, May 11, 1993). Beginning in 1996, small businesses were defined as those employing no more than 100 people

How does *Maxim's* restaurant survive? “High prices” was the firm answering of the owner. Taxing the consumer by imposing high prices is the way of survival: in Moscow, where the average monthly income is \$300, customers can expect to pay \$40–50 per person at most restaurants (Chernov, 2003). Establishing cheaper restaurants is only feasible by big businesses, which can get protection from high-level city and federal bureaucrats and which can maintain profitability by sheer volume: Rosinter Restaurants, a franchise of the U.S. chain TGI Friday's, and McDonald's have 100 and 48 locations respectively, and earn over \$50 million dollars annually (Russian Economic Overview 2002). Taxing consumers through the imposition of higher prices on products and services is practiced all across the nation. This tax is estimated at 10% on average — e.g., the price of goods and services are 10% higher than they would be if there were no such bureaucratic barriers to business (Tambovtsev, 2001b). The political implications are obviously negative. Observers conclude that “the Russian experiment with parliamentary democracy is more or less dead.”<sup>17,18</sup>

True, in 2001 the government of newly elected President Vladimir Putin passed several laws aimed at reducing bureaucratic pressure over business. Among the most acclaimed measures was the 13% flat tax on profits, a licensing law that reduces the number of permits that businesses must obtain from bureaucratic agencies. There was also a law creating a “one-window” process for registering businesses — instead of the usual 20–30 windows — as well as some initiatives of lesser consequence. Two years later, however, observers have reached some poor conclusions. The number of required permits is again on the rise, and it is harder than ever to get licenses and certificates. The “one-window” registration rule does not work; a prospective business owner must deal with at least six or seven different agencies, and spend at least one month waiting in queues. Thus, the demand for middlemen has not suffered. Though the government fired a couple thousand inspectors and controllers, the reduction amounted to less than 0,25% of the total. Regardless, a law that sought to

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(Federal Law № 88-FZ, June 14, 1995). There are no statistics for 1996–2001 on the number of small businesses with 200 employees. Experts believe that because the 1996 law deprived small businesses with 200 employees of some important tax exemptions and benefits, some of those businesses split in two and registered as two small businesses in the respective governmental organizations. Others simply moved outside the legal realm by not registering at all (Vasiliev, 2000). Thus, this table first and foremost represents the trend (i.e., decline) in the number of small businesses in Russia.

<sup>17</sup> *The Economist*, “The Russian Elections, Putin's Way: Russia's experiment with parliamentary democracy, never full-hearted, is more or less dead. The country's wellbeing now depends more than ever on one man” December 13–19, 2003.

<sup>18</sup> In the paper written six weeks before the 2003 parliamentary elections, Andrei Shleifer and Daniel Treisman argued that Russian transition, in fact, has been relatively successful. They further argued that by 2003 it had become a normal country: “A typical middle-income capitalist democracy” which had secured its place among other countries of its category, such as Argentina and Mexico (Andrei Shleifer and Daniel Treisman, “A Normal Country” (2003). Available from: <http://post.economics.harvard.edu/faculty/shleifer/shleifer.html>).

constrain different types of inspectors and controllers did not include law enforcement agencies — such as police, tax inspection and FSB — that disturb small businesses the most. Furthermore, the new Administrative Code increased the number of agencies that are allowed to exercise control functions over businesses from forty-three to sixty.<sup>19</sup> Following is an example, of how bureaucrats are capable of turning progressive laws to their own ends. On January 1, 2001, Russian Customs introduced a new, more business-friendly system of taxing imported goods. The primary goal of the new system was to reduce corruption and make the process less time consuming. In accordance with the new regulation, five tariffs were introduced, ranging from five% of the total value of goods to 30%. Naturally, Andrei Illarionov, the presidential economic advisor, argued that the existence of five tariffs as opposed to two was in itself a road to corruption (Illarionov, 2000). Still, businesses were quite encouraged — for two days. On January 3, two days later, the State Custom Committee’s central directorate issued Order № 2, which decreed that all goods claiming the lowest tax rate (5%) were required to obtain an approval stamp either from the head of directorate or from his deputy. As a result, the queue to get that approval stamp became as long as several months, and thus, implied a higher bribe. Retail storage facilities in nearby states got stuck with unshipped goods, and the price for home electrics in Moscow and other cities in the central region went up 15—25%.<sup>20</sup>

To cut the long story short, in a study of small business conducted in the summer of 2003, 50% of owners confessed that “the situation has not improved” and 46% claim that “it has become worse” (Borisov, 2003).

## 2. The Logic of Bureaucratic Action

Obviously, rent-seeking aspirations on the part of bureaucrats is not a purely Russian phenomenon. As James Buchanan argued quite some time ago, no administrative system is immune from these types of pitfalls (Buchanan et al., 1980).<sup>21</sup> It is also reasonable to accept that bureaucratic corruption is sometimes helpful, and that “bribery may be socially requisite for the survival of a society crushed by the incubus of an overpowering bureaucracy” (Riggs, 1964: 263).<sup>22</sup> In fact, the entire existence of the gray economy in the Soviet Union — read, survival of the entre-

<sup>19</sup> Irina Xachamada, “Maliy Bisnes: Chto v Davose Chorosho, to v Rossii” (Small Business: What is Good for Davos, for Russia [is Bad]), *Vedomosti*, 10 February 2003; Elena Vichucholeva and Elena Zagorodnaya “Poterya Lica” (Losing the Face), *Izvestia*, 13 December 2003.

<sup>20</sup> Yuri Ryzhski, Tamozhny Vzyla Dobro (Customs Took Over Goods), *Moskovski Komsomoletz*, 21 February 2001.

<sup>21</sup> James Buchanan, Robert Tollison & Gordon Tullock, *Toward a Theory of the Rent-Seeking Society* (College Station: Texas A & M University Press, 1980).

<sup>22</sup> Several other authors also argue that the optimal level of corruption is positive. See, Samuel Huntington, *Political Order in Changing Societies*, New Haven, CT: Yale University Press, 1968; Andrei

preneurial talent of the nation — would not be feasible without bribery. Economic reforms in the early 1990s led to a democratization of bribery, whereas earlier bribery was a privilege: a faculty of access to the relatively few in the Soviet bureaucracy who had attained the benefit of a free hand in the system of strict control and who allowed corruption (Yakovlev, 2001: 289–290).<sup>23</sup> This democratization of the system of bribery contributed at large to the blossom of small business through the politically (and otherwise) chaotic years from 1991 to 1995, creating ever better rent-extracting opportunities for bureaucrats of all levels (see Table 5).

Yet, with the regime approaching a more stable phase, the situation has, counter intuitively, begun to turn for the worse for small business. Instead of nourishing this golden goose, bureaucrats, rather irrationally, have been consistently reducing its ability to give golden eggs. Using Mancur Olson's analogy, the roving bandits, (e.g., the multitude of bureaucrats and criminals engaged in robbing businesses) have been replaced by a stationary one: the executive himself, who was supposed to constrain the bandits so as to preserve future harvests for himself (Olson, 2000).<sup>24</sup> However, the life of small business has not become any easier, but rather more difficult, and consequently the number of small businesses plummeted. Criminal rackets, despite all their side effects, apparently continue to be more users friendly. Conversely, efforts by the executive to conceal bureaucratic corruption in the years of President Vladimir Putin's authoritarian regime (beginning March of 2000) evoked an outcry from those who were to benefit the most from those efforts. Bribes (for entry and ride tickets) have again become a privilege, gained either through important connections or through a high price tag. As told by an owner of a small business, "the tougher the laws, the higher the prices that middlemen charge;" if before one could get away with giving one hundred dollars directly to a fire inspector, nowadays one "must find a middleman who will ask you to buy a fire extinguisher for a price three times higher than the real one [which is camouflage for the bribe]."<sup>25</sup> At first it sounds bizarre: a strong executive should be able to kick out all the middlemen and to collect the bribes for himself, as Olson said. By doing so, he would reduce transaction fees incurred by businesses. This is true if an executive's support base lies outside the bureaucracy: in the military, for instance. However, if his main constituency lies with the bureaucracy and he depends upon their support (which he does, because he is at odds with the other interests groups around him), then he has share the bribes with them, and he must allow corruption. In other words, in the same way that merely partial reforms

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Shleifer, Robert Vishny, "Corruption" *The Quarterly Journal of Economics*, 108:3 (August, 1993): 599–617. Available from: <http://links.jstor.org/>.

<sup>23</sup> Alexander Yakovlev, *Omut Pamyti: Ot Stolupina Do Putina*, Vol. 1 (Moscow: Vagrius, 2001).

<sup>24</sup> Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships* (New York: Basic Books, 2000).

<sup>25</sup> Ella Poneych, Pravila Igri: Sam Dolzhen Ponimat's (Rules of the Game: One Should Understand Them), *Vedomosti*, 18 November 2003.

can be almost as bad as no reforms at all (Hellmann, 1999), the same is true for efforts of coercion: an executive must choose to play the role of Stalin or he has to allow others to participate in bribes as well. If he chooses the latter case, small and middle size businesses — by virtue of being easy targets — suffer the most.

As the price of operating in the legal realm becomes far too excessive, businesses are prone to move into the gray zone of the unofficial market (De Soto, 1989),<sup>26</sup> thus depriving at least some bureaucrats of rents that they would otherwise have been able to extract. Owners may even close the business, thereby reducing the bureaucratic rent harvest even further. A paradox? No, I would argue that there is no paradox. Rather, there is a clear-cut logic to the actions of bureaucrats.

After all, the business of extracting bribes is risky: there is the imminent threat of populist “clean hands” campaigns, as the one conducted in Russia during the 2003 election cycle that resulted in the arrest of several top-level police officers precisely for imposing and extracting rents from businesses.<sup>27</sup> It is especially dangerous for the large majority of bureaucrats on various levels of the hierarchy who do not have the option of leaving public service and investing their accumulated bribe money in the market. Thus, “control, and again control” as Vladimir Lenin proclaimed at the beginning of the construction of the Soviet bureaucratic state. To be sure, control does not preclude bribery, but rather gives security to the process. It involves sharing bribes with both the superiors and subordinates, and thus provides for protection and allows one to avoid competition for bribes from the side of intruders. Moreover, control secures the option of moving to a private firm, if prosecution is threatened. However, control over many is a huge task: the bureaucratic machine of the USSR, with its enormous capacity for coercion, failed the task. As noted earlier, “illegal business activity” accounted for approximately 10% of the economic activity of the entire nation in the late 1980s. Therefore, killing small business via imposing barriers to entry, or through the heavy-handed regulation of operations, is a rational choice: first, by the rule of supply and demand, bribery becomes a privi-

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<sup>26</sup> Hernando De Soto, *The Other Path* (New York: Harper and Row, 1989).

<sup>27</sup> In June 2003, an anti-corruption campaign was started, which became known in the media as the “wolves in sheep’s clothing” campaign. This was part of the election strategy of the pro-Kremlin party “United Russia” led by Boris Gryzlov, who happened to be the Minister of Interior, besides being the leader of the party. Because of this campaign, at least seven top-level police officers with the rank of colonel and higher were arrested on charges of extortion. The list of items found in just one apartment of a police officer speaks for itself: among other things, it included \$3,320,000 in cash, 20 various pistols, 45 key chains from cars like “Mercedes” and “BMW” special surveillance equipment, lots of expensive jewelry, and twelve expensive (\$4,76—023,000) Patek Philippe watches. This list suggests that the colonel under arrest did not collect all those valuables himself, but merely sat on top of the chain of police officers that supervise businesses: the kind of officials described in the first part of the chapter. Thanks to this campaign, some price tags for the position of top-level police officers in the city have become known. It ranges from \$25,000 for the post of mayor or colonel, to \$120,000 for the post of police general. Zinaida Lobanova et al. 2003. Menti bez Grima (Policemen without Makeup), *Komsomolskaya Pravda*, 24 June 2003; Available from: <http://www.kp.ru/daily/23057/4544>; Accessed December 22, 2003.



lege (the stricter the control, the more demand for bureaucratic favors) and thus, the price goes higher. Secondly, big business will fill the void.

Consider again the list of documents that must be obtained in order to start a restaurant business in Moscow. It is evident that bureaucrats may exercise their power over business through three types of activities: (1) selling various permits to enter the market and then to operate in it (licenses and certificates), (2) providing expertise on compliance with rules and regulations (GUPs), and (3) by conducting regular check-ups of everyday business operations (law-enforcement and other control agencies). Each of these practices was born and tested in the Soviet bureaucratic system, and each one was reinstated by the new laws (e.g., they are not leftovers from the USSR-type “rule of law” but have undergone adjustment to the new economic environment). Each activity in itself provides an opportunity for extracting bribes. But when taken together, the three practices — interdependent upon each other — provide for something much more promising than a petty, one-time bribe: they establish *control* over the market field, which in turn ensures the constant flow of rents and de facto property rights over businesses.

Following is discussion of controlling institutions, presented in ascending order, from those least harmful to business to those capable of imposing the greatest burdens and/or exercising the greatest control over the wider range of entrepreneurial activity: GUPs, certification, licensing.

### *GUPs*

State property enterprises (*gosudarstvenniye unitarniye predpriatia*) are the kind of creatures in which the property belongs to the state but the managers enjoy the profits. They originated in the last two decades of the Soviet Union, the outcome of the then-quasi market reforms known as *xozrachel* (self-supporting or self-financing enterprises) which were meant to bring efficiency to state enterprises by creating additional incentives for the state-appointed managers (Yasin et al., 2002).<sup>28</sup> In the reality of the Russian transition, GUPs (identified by various labels such as “privately-traded company, Ltd.” “openly-held company” etc.)<sup>29</sup> have become a form of gratitude bestowed upon federal and local bureaucrats by the federal executive as a reward for loyalty. In the chaotic and politically uncertain autumn of 1992, Boris Yeltsin, in a special presidential decree, spelled out the right of bureaucrats to create semi-private organizations: the property would belong to the state, but the profits would be private.<sup>30</sup> This has resulted in a convenient way of selling state ser-

<sup>28</sup> Yevgenii Yasin et al. “Bremya Gosudarstava I Ekonomicheskaya Politika” (Burden of the State and Economic Policy), Liberal Mission Fund, October 22, 2002; Available from: <http://www.liberal.ru/sitan.asp?Num=276>.

<sup>29</sup> Ibid.

<sup>30</sup> Presidential Order № 1230, October 14, 1992; Sobraniye Aktov Prezidenta and Pravitelstva RF (Collection of Acts of the President and the Government of the RF), 1992, № 16, p. 1237.

vices in commercial packaging, or, in other words, a way to legitimize bribery. This became much more necessary for bureaucrats after the 1995 federal law on state service prohibited bureaucrats from conducting commercial activities out of their offices: GUPs have been organizations which stood apart from the state administration. (Of course, any law in Russia allows for exceptions. Thus, for example, the Kremlin's Business Administration Directorate (which provides benefits to executive — level bureaucrats) enjoys special presidential decrees — be they from Boris Yeltsin or Vladimir Putin — that allow the directorate to engage in commercial activity despite being an office of the state administration.<sup>31</sup>

The heads of the respective agencies — federal or local — appoint managers of GUPs thus creating incentives for managers to share the profits and for agencies to protect their existence.<sup>32</sup> There are over 22,000 such enterprises in existence across the nation, of which almost 10,000 (9,810, to be exact) belong to the federal administration (Yasin et al., 2002).<sup>33</sup> GUPs, as is often acknowledged in the government documents,<sup>34</sup> are a burden on federal and local budgets: according to official statistics, 40% of those enterprises are operating at a loss, and an additional 20% have a profitability close to zero.<sup>35</sup> In December 2001, President Vladimir Putin signed a federal law requesting a drastic reduction in the number of GUPs.<sup>36</sup> However, two years later, in 2003, ninety-two new federal — level GUPs were created,<sup>37</sup> and an additional seventy or more have been created under the auspices of local administrations.<sup>38</sup>

That study also reveal that in more than half of Russia's regions, local authorities have increased their presence in private firms. Thus, the size and volume of

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<sup>31</sup> See, for example: Presidential Decree № 1444, "Voprosi Upravleniya Delami Prezidenta RF" (Questions of the Business Administration Directorate), August 7, 2000.

<sup>32</sup> Igor Nikolaev, Ivan Shulga, "Firma po imeni GUP" (Firm under the name GUP), *Moskovskie Novosti*, 23 September 2003, № 37.

<sup>33</sup> Yevgenii Yasin et al., 2002.

<sup>34</sup> On May 23, 1994, then-President Boris Yeltsin signed a presidential order "On reform of the State Enterprises" which acknowledged the necessity of concealing the practice of the establishment of new GUPs, and to proceed with the privatization of the existing ones. It had little if any effect. In 2002 alone, twenty-seven different governmental orders were issued, including two federal laws regarding privatization of GUPs. See: official website of the Ministry for State Property (<http://www.mgi.ru/base/privat>).

<sup>35</sup> Alexander Braverman, Deputy Minister for State Property, as quoted in: Gosudarstvenniye Unitranniye Predpriyatiya Zhdet Mashtabnaya Reforms (GUPs are to be Reformed at Large), *strana.ru*, 2 June 2002. Available from: <http://www.strana.ru/stories/02/02/06/2463/170857.html>.

<sup>36</sup> Federal Law № 178-FZ, "O Privatizatsii Gosudarstvennogo I Munitsipalnogo Imushchestva" (On Privatization of Munciber and State Property), December 21, 2001.

<sup>37</sup> "Pomogiti Putinu" (Help Putin), *Vedomosti*, 6 February 2003.

<sup>38</sup> Research was conducted by the *Standard and Poor* international credit agency. Results of the growth of bureaucratic businesses are for 27 out of 89 regions of the Russian Federation. Cited in: Tatyana Kordukova, Pavel Kochanov, Neprozrachnoye Vmeshatel'stvo (Non-Transparent [State] Intervention), *Vedomosti*, 9 April 2002.

state presence in the economy via GUPs and other bureaucratic businesses is on the rise.<sup>39</sup> Why? As learned from interviews, as well as documents and publications in the press, there are two major reasons for this. For one, because the operating expenses of bureaucratic businesses are paid from the state budget, they are quite profitable for their managers and the officials who establish and supervise them. Unlike businesses in the private sector, GUPs do not pay tax on income, they enjoy special discount utility rates, and they do not expend funds on their primary sources of production, which are provided by the state. Nor do they incur costs on property rental, guards, etc. We may assume that they are also excused from the bribes extorted by control agencies: the state itself serves as their *krysha*. Thus, the estimated net profit (which almost never reaches the owner of the property — i.e., the state) of some GUPs is \$5 million.<sup>40</sup>

Following is one example of such a business. In accordance with a governmental decree,<sup>41</sup> beginning January 1, 1999, nearly all consumer products imported to Russia — from cheap tea to electronics — were obliged to obtain a special stamp in the form of a hologram.<sup>42</sup> Supply and distribution of these holograms were assigned to a privately-traded company called “Specznak” a subsidiary of the State Committee for Standardization and Metrology, with \$300 (sic!) in start-up capital. The net price of each hologram, which the company did not produce (but rather bought from companies outside the country, thereby avoiding production and labor expenses), was only 0,8 cents. However, the price charged to retailers was 19 cents for each stamp. Thus, given transportation and other probable costs involved, the bureaucratic business had an estimated profitability of 4000%, according to a special report prepared for the cabinet of ministers (Tambovtsev, 2001b). Given that 40% of the “privately-traded company, Gosznak” was the property of subsidiaries registered off-shore,<sup>43</sup> one may assume that the profits ended up in the bank accounts of the bureaucrats involved in the business.<sup>44</sup> The state budget did not benefit one cent from the hologram stamps,

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<sup>39</sup> Ibid.

<sup>40</sup> Estimation of the Treasury Chamber as cited in: Igor Nikolaev, Ivan Shulga, 2003.

<sup>41</sup> Decree of the Government of the Russian Federation № 601, May 17, 1997.

<sup>42</sup> In July 1999, liquor was excluded from the list of products obliged to carry the hologram stamps. Given that one of the reasons for instituting the hologram stamp system was “the protection of consumers from illegally-produced products” (Ibid.), it is yet another example that anything but the public interest drives the multiplication of bureaucratic barriers to businesses.

<sup>43</sup> Yuri Ryzhskii, *Nenapisannyi Doklad* (Never Written Report), *Moskovskii Komsomolets*, 21 February 2001.

<sup>44</sup> This new tax on business evoked an outcry from the side of the entrepreneurial community as well as liberal politicians. The battle lasted for three years, until the stamps were abandoned by Governmental Decree, № 82, February 6, 2002. In between, there were three other decrees issued by the federal government and signed into law by three different prime ministers: Viktor Chernomyrdin, Yevgenii Primakov and Sergei Stepashin. None had the guts to cancel the obviously harmful decision, but each apparently was lobbied by different types of business: Viktor Chernomyrdin, who originally took responsibility for the decision, moved the date of instituting the hologram stamps from January to April 1999;

even though the initial calculations suggested that the federal budget would gain \$200–300 million from the practice. An investigation found that all proceeds from the deal went to a company called “Interstandart” (Kruchkova, 2001:11). Additional spice was given to the story when it was learned that “Gosnak” was closely associated with Gennadii Seleznev, the then-speaker of the lower chamber of the Russian parliament, who became an MP on the Communist Party ticket.<sup>45</sup>

The second reason for the rise in the number of GUPs despite their burden to state and local budgets is that these bureaucratic businesses are an essential element in the state’s control over business. In fact, an open-ended questionnaire administered by analysts from *Standard and Poor*, the international credit-rating agency, revealed that 80% of bureaucrats considered state presence in private firms as a necessary means to control the economy.<sup>46</sup>

### *Certification*

Certification of products and services is yet another remnant of the Soviet bureaucratic state. In the USSR, there existed *gosudarstvenniye standarti* (state standards), or GOST, which prescribed standards for the majority of products and services that existed in the country. In the new Russia, a system of certification was re-introduced in 1993 by the federal law “On Certification.” The reasoning for this was nothing new: public interest, and the necessity of protecting consumers from dangerous products and services. Since then, certification has apparently expanded into a profitable industry: there are approximately 4,000 firms (special agencies and test laboratories) that conduct certification of goods in the name of the state. Without this certification, no business may conduct their activities, be it a grocery, restaurant or electronics retailer (Tambovtsev, 2001a). As of 2003, 80% of all consumer goods are obliged to obtain a certificate of compliance with state-imposed standards (Kruchkova, 2001:7). For the sake of comparison, in the countries of the European Union, only 4% of consumer goods are subject to obligatory certification;<sup>47</sup> moreover, the EU has just ten agencies (compared to the 4,000 that exist in Russia) involved in certification.<sup>48</sup> Critics denounce the public interest justification of

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Yevgenii Primakov moved the date from April 1999 to July 1999 (Governmental decree № 1223, October 20, 1998); Sergei Stepashin, who held the office for only two months, moved the date to October 1999, and excluded alcohol from the list. One may assume that *transactional costs* and favors were involved. However, the profitability of the bureaucratic business was such that three prime ministers responding to business lobbies could do nothing more but move the date.

<sup>45</sup> Yuri Ryzhskii, 2001.

<sup>46</sup> Tatyana Kordukova & Pavel Kochanov, 2002.

<sup>47</sup> Ibid.

<sup>48</sup> Boris Alyshin, Deputy Prime Minister of the Russian government (2003–present) as cited in: Ekaterina Katz, “Vzyatki Budut, no Ich Stanet Menshe” (Bribes will Keep Existing, but there will be a Little Bit Less [of bribes])” *Gazeta*, 3 February 2003.

the certification system as nonsense. They argue, for instance, that 60% of the state standards in existence are leftover from the Soviet-era's Gosstandart (the Ministry for Standardization in the USSR). Given the notoriously ill quality of goods and services that existed in the USSR, it is hardly possible to apply those standards to the current merchandise, much of which is produced in the European Union and the US (Tambovtsev, 2001b). Furthermore, statistics suggest that state-assigned certification agencies and firms reject only about 2% of goods, whereas 30% of already-certified goods are rejected as bad by traders: apparently, the market is much more cautious than the bureaucrats and their colleagues in the certification business (Kruchkova, 2001:7).

Researchers from the Moscow-based magazine *Spros* — a publication of the national Confederation of Consumers — conducted a test of twelve of the most popular kettle-boilers on the market. It was discovered that eight brands and models did not comply with fire protection rules. However, each brand and model received an approval certification stamp *prior* to the research. When the Ministry for Standardization was given the results of the test, they reacted in a remarkable fashion: they denied any responsibility for the appearance of the dangerous products on the market. Instead, the retailers who sold kettle-boilers (and who, again, had obtained the state's permission to sell those products) were fined.<sup>49</sup>

Another highly acclaimed example concerns the production of illegal vodka. In the early 1990s, the market was overwhelmed by the intrusion of dangerous substitutes, which subsequently led to a sharp rise in the death rate from alcohol poisoning. The government issued literally hundreds of documents regulating the industry, to no avail: illegal vodka kept arriving on the market, mostly from the provinces in the Northern Caucasus. “[The] State found itself totally powerless, until the Association of Alcohol Producers [an umbrella lobbying organization for producers of alcohol] put their guards on each and every train coming from the Caucasus. Whatever means they employed — and I am sure there were some violent ones as well — the reduction in the volume of illegal vodka was stunning: it virtually disappeared” a top-ranking official told the author (Pavlenko, 2001).<sup>50</sup>

Unlike with the mafia, businesses find themselves helpless when it comes to bureaucratic control: either they must pay their way through or attempt comply with the impossible rules. “There is no way to fight [with imposed regulations] including via the judiciary” Vitali Tambovtsev, a professor in the Economics Department at Moscow State University, and a long-time scholar of the problem, told the author. “There exist some 60,000 documents that describe the state's demands for the quality and safety of goods produced or imported. Thus, [should business sue bureau-

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<sup>49</sup>*Spros*, № 10, 1999; № 2, 2001.

<sup>50</sup> Sergei Pavlenko, Head of the Department, Administration of the President, 1997–1998, chief of secretariat of the First Deputy to Prime Minister Aleksei Kudrin, 2000–present. Interview with Yevgenia Albats, May 2001.

crats] there always will be a document that will find bureaucrats right and business wrong.” As was the case with a start-up restaurant, it turned out that the size of the kitchen table, on which meat is cut, was specified in the certificate as well. As for the meat itself, there is a certificate that the seller of the meat must obtain, and there is a certificate for turning that meat into a dish (Maxim, 2001). Overall, the estimated volume of the business of certification is around \$120–150 million, of which only a fraction is paid to federal and local budgets (Kruchkova, 2001:8).

In 2002, a year after the Russian government approved a much-acclaimed program on reducing bureaucratic pressure over business, the Ministry for Standardization came out with yet another new set of norms. This time, bureaucrats had developed state norms for janitors. In accordance with these new norms, office cleaning was classified according to four types: primary, daily, weekly, and the major one. While exercising the latter type, a cleaner should perform twenty-five duties described in a list. Next, there are prescribed rules concerning how to check the quality of the job done. Thus, from now on, any firm that sells cleaning services must obtain a certificate on cleaning services, and comply with the standards prescribed by the federal administration (Auzan, 2003). Sound ridiculous? Not exactly for one who lived in the Soviet Union: bureaucrats of the Russian state administration behave the way they learned and became accustomed to back in the times when they felt secure and comfortable, and they had control over Russian citizens’ birth, death, and everything in between.

### *Licensing*

This is the most effective — and most harmful — tool possessed by bureaucrats for control over entrepreneurial activities. Licenses are special permits that start-up businesses must obtain from the bureaucratic agencies in order to begin operations. By denying a permit, or by demanding a prohibitively high price for the permit, bureaucrats resolve the problem of efficiency of control: they reduce the number of businesses that may operate in the legal realm. Those businesses that dare to start activity without an entry permit are doomed to operate in the gray zone of the unofficial economy: by doing so, they deprive themselves of both legal protection (and thus are forced to pay bribes to law enforcement agencies and *krysha*) and political opportunities to lobby their interests. As Simeon Djankov et al showed in their comparative study of regulation of business start-ups in eighty-five countries, high official costs of entry correlate closely to “higher corruption and higher unofficial economies, but not better quality of public or private goods” (Djankov, La Porta, de Silanes and Shleifer, 2001).<sup>51</sup> Russia is described in the study as one of the worst cases.

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<sup>51</sup> Simeon Djankov et al., “The Regulation of Entry” *Quarterly Journal of Economics* (February 2002).

The myriad of licenses promotes bureaucratic businesses such as GUPs (which are not required to obtain a license or are granted one at creation), gives a boost to certification (a license stipulates compliance with standards and regulations outlined by the state) and creates fertile ground for the extraction of rents by all kinds of controllers who, among other things, are obliged with the task of checking the permits. In previous chapters, I have referred several times to the problem of licensing as a signature example of the reformers' failure to overcome the bureaucratic stranglehold on the nation's economy and on small business, the most hopeful and promising component of the prospective civil society, in particular. This failure has led in turn to: the development of non-market competition; the creation of a market dominated by monopolies; high prices on everyday goods; the practice of rent extraction by bureaucrats of the executive and managerial levels who have incentives to protect the system of regulation of entry despite its known harm to the nation's economy and general economic transition, acknowledged even by the nation's leading politicians including the chief executive.

The existence of a somewhat coherent and consistent set of data on licenses (unlike it is the case with other types of regulations) — spanning the decade-long period of Russia's economic transition — allows for more than just the recitation of anecdotes acknowledging the effect. It allows us to see how and why the whole system of bureaucratic control, once destroyed with the collapse of the USSR, managed to revive, evolve and thrive in the new political and economic environment.

There are two sets of data that can be used for this analysis. One set describes the type and number of business activities that have been affected by entry regulations throughout the years of transition, and the impact that those laws have had on the transition process (Table 6). Unfortunately, this data is not really operational: it is based on approximations, compiled from the work of numerous (though reliable) experts, and it does not show the impact of politics on the development of the system of control. Still, it shows three important trends. First, it shows that the mere existence of laws does not provide for the rule of law: the return of licenses eliminated by the laws in the same (or slightly different) wording was as high as 75%. Second, except for the very first period of transition (1991—1993), the pace of the bureaucratic encroachment on business has been quite stable.<sup>52</sup>

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<sup>52</sup> The beginning of the system of licensing is usually attributed to the Soviet law, "O Kooperatsii v SSSR" (*On Cooperatives in the USSR*), dated May 26, 1988. This law allowed for the existence of private enterprise in the Soviet Union. This law clearly stated that the state has control over those new enterprises. Next came the 1990 law, "O Predpriyatiyach i Predprinimatelskoy Deyatelnosti" (*On [commercial] Enterprises and Entrepreneurial Activities*) which stipulated the right of the state to regulate business activity via permits on entry (licensing). However, the law did not acknowledge any clearly defined rules. The next law came in 1993: Federal Government Executive Order № 492, May 27, 1993. This law acknowledged the right of local authorities to regulate entry to the market, and gave a free hand to federal and local bureaucrats to issue all kinds of licenses. (See: Olga Makarova, "O Sostoyanii Licenziyonnoy Deyatelnosti v Rossiyskoi Federatsii" (*On the State of Licensing Activities in the Russian Federation*), *Vestnik of the Working Center of Economic Reforms*, № 101, June 2000.



Third, there is a tendency for secrecy: if we consider that, under the 1998 law, 57% of licenses were outside federal law and were rather in the form of secret presidential and governmental decrees, and then three years later, in 2001, the number of secretive rules went up by almost 20%, thereby accounting for 78,5% of licenses. In the same period, the total number of business activities that require licenses decreased by just 3,2%, compared to the 1998 law. Given the increasing secrecy, that has been a landmark of the presidency of Vladimir Putin, I doubt that any accurate data will be available in the future, and Russian specialists will have to rely on the techniques of data estimation used by their predecessors, the Sovietologists.<sup>53</sup>

Another value of this data set is that it allows one to see a complete cycle from beginning to end, and then the transition to the next cycle. For instance, by the time the first coherent law was passed to constrain bureaucratic activities in the field of licensing, in 1994, there were 2,500 types of business activities that required a permit on entry. The law specified just 495 such activities, assuming that bureaucrats were going to follow the new rule. However, by 1998, when yet another law was passed aimed at exactly the same purpose — to bring order to bureaucratic regulations — there were already 2,000 business activities that required a permit on entry (e.g., 1,505 new regulations had appeared since the previous law). The 1998 federal law passed by the government of Yevgenii Primakov marked the beginning of yet another cycle: it reduced the amount of licensing activities by the agencies in the following two years, but the volume of regulations remained the same despite the wording of the new law. Finally, another much more detailed and supposedly efficient federal law was passed in 2001, in accordance with the program of further economic liberalization proclaimed by the newly elected President Vladimir Putin. Thus, 2001 was the beginning of the new cycle. No data is yet available to evaluate the difference between the language of the new law and its effectiveness: reports in the media and in some databases show that still new regulations have been passed since 2001. In fact, the day after the new law was passed by the State Duma, a new permit was born: the federal government decided to impose control over businesses engaged in auditing activities.<sup>54</sup>

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<sup>53</sup> Beginning in 2001, complete data compiled by the State Committee for Statistics once again became a privilege. According to the agency's executive, who spoke on condition of anonymity, some 15 top officials both in the Kremlin and the Federal Government, receive the complete data; another 150 or so officials have access to limited data, while everybody else gets the kind of data published by the agency. Of course, the source did not mean the data that has always been classified by virtue of national security concerns.

<sup>54</sup> Four months later the decision took the form of yet another federal law "On Auditing Activities", № 164-FZ, December 14, 2001. Ministry of Finance has been the agency benefited the most out that set of controls.



**Table 6.** *Number of business activities under licensing with respect to laws on licensing*

Year when law was passed	1994			1998			2001		
Type of legal document	Executive Decree of the Federal Government № 1418			Federal Law № 158			Federal Law № 128		
	Prior to the law	Stipulated by the law	Total (including agencies not in the law)	Prior to the law	Stipulated by the law	Total (including agencies not in the law)	Prior to the law	Stipulated by the law	Total (including agencies not in the law)
Number of business activities under licensing	2500	495	No data	2000	215	500	2000	104	484

Source: *Working Center of Economic Reforms under the Government of the RF; Olga Makarova(2000), Yevgenii Yasin(1999), Viktor Pleskachevskii (2002).*

The second set of data, which I compiled from databases of official documents, deals with regulations produced in different formats (laws, presidential decrees, and executive orders) that were issued over the course of eleven years by various institutions of the federal authority: the president, the federal government, the legislature and the federal agencies. These documents established new licensing requirements (adding to the pile developed over previous years), made additions to existing ones, or reconfirmed and/or redirected old ones.<sup>55</sup> Unexpectedly, the total number of documents that comprised the data set (2278) referred to the estimated number of business activities (2000–2500)<sup>56</sup> which had been under licensing until 2001 (Table 7).

<sup>55</sup> This data was compiled by the author from two Moscow-based information databases of official documents, namely *Labas* and *Consultant*. The first one served as the primary source. The choice was inspired by the fact that *Labas* has been used by the *Working Center of Economic Reforms*, which has been researching and analyzing the problem of licensing start-ups since 1992. My data was picked from a set of some forty thousand documents. Two important notes: (1) my data set does not include documents issued by local authorities. Until recently, the Russian Federation consisted of 89 regions and, beginning in 1992, each local body had the same right as federal agencies to issue permits on entry. However, there is no consistent data inclusive of all regions. (2) Russian licenses are like Russian *matreshka*: inside each one, there is another. For instance, there exist licenses on fire fighting activities. Inside are several others: on making fire fighting equipment (such as fire extinguishes and ladders), on making fire fighter clothing, on providing fire fighting services, etc. I have attempted to reflect that multiplication of licenses in my data set.

<sup>56</sup> The truth is that no one institution, researcher or official in the country knows the real numbers (Yasin, 2000; Makarova, 2001).

**Table 7.** *Licensing by year and institution*

	President	Federal Government	Legislature	Agencies	Total
1988—Nov. 1991 <sup>57</sup>	0	9	6	25	40
Nov. 1991—1992	15	34	12	72	133
1993	17	49	8	121	195
1994	9	57	3	174	243
1995	8	55	34	132	229
1996	10	63	23	155	251
1997	9	39	15	199	262
1998	7	59	28	214	308
1999	7	44	21	164	236
2000	4	51	7	155	217
2001	2	69	5	88	164
TOTAL	88	529	162	1499	2278

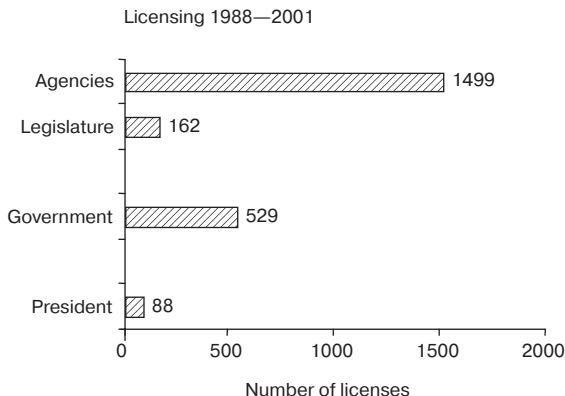
*Source: Labas database, Consultant data base, Yevgenia Albats.*

Two things arrest our attention right away. One is that elected institutions such as the executive and the legislature<sup>58</sup> (e.g., institutions that depend upon constituency, and hence should be especially concerned about protecting the constituency from market failure) are the least involved in issuing rulings aimed at controlling businesses. Taken together, these two institutions are responsible for slightly less than 10% of all existing regulations. Furthermore, the federal government — which is somewhat accountable to the constituency by the fact that the prime minister is appointed through the dual action of the president who nominates the candidate and the legislature which approves that choice — accounts for only 23%. Instead, the entities responsible for 66% of established regulations are the federal agencies: using the loopholes in laws and executive orders, the non-transparency of their agencies and the weak and corrupted legal system, bureaucrats who have no constituency whatsoever issue in-house regulations that inhibit the development of small business.

<sup>57</sup> On November 6, 1991, the first reform government (known as Yegor Gaidar's government) was born. Until then, Ivan Silaev was the chairperson of the government of the Russian Federation.

<sup>58</sup> During the eleven-year period described in the table, the Russian legislature had two names. Until September 21, 1993, it was the Supreme Soviet of the Russian Federation. Since December 1993 it has been known as the State Duma. For the purpose of coherence, I use the term "legislature."

**Figure 2.** *Licensing 1988–2001*



We may conclude from this data that anything but public interest has served as a reason for imposing controls over the market field.<sup>59</sup>

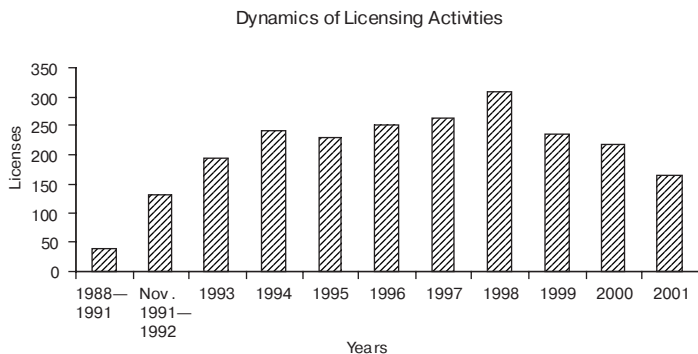
Interestingly, this data somewhat contradicts the common sense perception that the Russian legislature, which was dominated by nationalists and communists all the way from the onset of reform in November 1991 through December 1999, was at large responsible for the failure to liberalize the nation's economy. At least in one instance — namely, the right of bureaucrats to control entry to the market — the legislature is much less guilty than the federal government and the agencies. These findings also dismiss ideological bias on the part of Russian bureaucrats (e.g., that by virtue of having been indoctrinated by communist ideals, they are prone to greater state involvement in the economy to ensure a more egalitarian distribution of the national wealth) as a plausible explanation for bureaucratic behavior. Should it be otherwise, their fellow communists in the legislature would have been expected to behave accordingly, whereas they did not.

The data set also suggests that the development of the system of bureaucratic control went through three distinct periods, which correspond somewhat to the three phases of transition outlined in my theoretical model. Consider for that Figure 3.

The first period lasted from the onset of entrepreneurial activity in 1988 through 1992. This phase was characterized by rather low licensing activity on the part of bureaucrats, as if they were in sleep mode. The second period, from 1993/1994, saw a torrent of regulations, which resulted in a peak of licensing activity in 1998,

<sup>59</sup> This finding fits predictions by the public choice family of models, which argue that strict regulations have little if anything to do with the public interest, but rather with a desire by politicians and bureaucrats to extract benefits for themselves (De Soto, 1990; Djankov et al., 2002).

**Figure 3.** *Dynamics of Licensing Activities*



the year of the financial collapse.<sup>60</sup> During this period, approximately 250 regulatory documents were passed each year (not including 1998, when such documents reached a historic high of 308). The third period, which began in 1999, has been marked so far by a decrease in licensing activity. Given that the ratio of open regulations compared to those outside public oversight in 2001 was 1 to 4,7, that decreasing trend should be reversed pretty soon by increase in secretive regulations.

Obviously, there should be reasons why the three periods are different. The simple (and valid) answer is that the development of the market simultaneously drove bureaucratic activity: more business actions (even if not agents) implies more possibilities to impose new regulations. It sounds perfectly reasonable, except for at least two obvious factors. First, in the initial years of reform, there were plenty of subjects to regulate. However, bureaucrats seemed to be concerned with something else. Second, it is not clear why there was a decrease in licensing activity in 1999, which continued through the following years. Even if my suspicions are right, and much of this information has become classified, still there should be an explanation of why fewer new executive orders were issued during the election cycle of 1999—2000, whereas during the 1995—1996 parliamentary elections the trend was just the opposite. Is it because bureaucrats became rational, and realized that they were killing the golden goose? Or they were unable to digest any more regulatory activity? Both possibilities imply a degree of unity on the part of bureaucrats, which as was described in the previous chapter, does not exist. So, what explains the difference between the three periods?

<sup>60</sup> It may seem that the difference between the 133 documents that established licenses in 1992 and the 195 documents in 1995 is not too big, unless you keep in mind that such regulatory documents were issued each year, adding dozens of business's activities to the list of those already under the bureaucratic control. Even in 2001, the year when the new law on licensing, highly advertised as the most liberal one yet, came into being, 164 documents were issued, not counting an unknown number of orders issued by the secretive agencies.

Though the first law that allowed for private entrepreneurship in the USSR was established in 1986<sup>61</sup>, the real start of private economic activity in the Soviet Union came with the May 26, 1988 law “On Cooperation in the USSR” (Radygin, 1994). In less than two years, there were officially registered 245,000 cooperatives, plus almost the same number operating unofficially; in addition, there were 672,000 private entrepreneurs.<sup>62</sup> By 1990, private enterprise accounted for 6.1% of the Gross National Product (Radygin, 1994:25)<sup>63</sup>. Therefore, the base for extracting rents already existed between 1988—1991. Yet, licensing activity on the part of bureaucrats barely existed. Only some forty documents were issued back then. Of course, state bureaucracy was perfectly aware of the possibility of controlling businesses via permits on entry and operation: the language of the laws always spelled out the rights of bureaucrats to intervene in business activity. Still, one of the first regulations that listed the kind of business activities that required a permit from the state appears to be extremely modest, and even reasonable, compared to what came later in the course of economic reform. The fields of regulation were clearly defined and were concerned with weapons production — from simple explosives to chemical and biological weapons. Next came regulations concerning energy supply — in a country as cold as Russia it seemed like a reasonable concern on the part of the administration. Further came regulations concerning access to natural resources (such as oil and gas), operations involving precious stones and radioactive materials, and issues dealing with transportation, communications, cryptology, and finally drugs.<sup>64</sup> Apparently, Soviet (and later, Russian) bureaucrats did not see the business of licensing as worth their time and effort.

There were several reasons for this.

First, in the final years of the USSR there was no need to officially define state control over private business. The majority of new private enterprises (which were cooperatives and amounted to 80% of all private business) were created under the patronage of managerial bureaucrats — the directors of state-owned enterprises (Radygin, 1994: 26). Thus, bureaucrats did not yet see these new private business-

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<sup>61</sup> The 1986 USSR Law “Ob Individualnoy Trudovoi Deyatelnosti” (On Individual Labor Activity) allowed the extraction of profits from *de facto* private property. Basically, this law was an attempt to legalize the market of non-government services that existed by the mid 1980s in the Soviet Union, which had come to involve approximately 18 million people (Radygin, 1994:25). By 1989, approximately 672,000 people were registered as private entrepreneurs. The large majority of those first businessmen were either in the field of hand-made goods or in services such as laundry, cleaning and tailoring.

<sup>62</sup> *Narodnoye Khozyaystvo SSSR v 1989 godu // Finaci i Statistika* (National Economy in 1989: Finances and Statistics), Moscow, 1990; Radygin, 1994:25.

<sup>63</sup> Alexander Radygin, *Reforma Sobstvennosti v Rossii: na Puti iz Proshlogo v Budushee* (Reform of Property in Russia: on the Way from Past to Future) (Moscow: Respublika publishing house, 1994).

<sup>64</sup> Resolution of the Supreme Soviet of the USSR, № 2195-1, May 28, 1991.

es as competitors. Second, bureaucrats from the state administration — industrial agencies, first and foremost — were busy converting state property into semi-government/semi-state organizations (Chubais, 2001 and Radygin, 1994<sup>65</sup>). Thus, they were not interested in imposing regulations that might also apply to their own future businesses.<sup>66</sup> However, the most important reason was that back in the dying years of the USSR, bureaucrats were busy with something else. The early 1990s was a period of almost spontaneous privatization of state property and resources, of which the financial resources of the nation were the most desirable commodity. As Mark Kramer wrote, it was a time “of a massive de facto privatization of cash flows that previously had been under the control of the Soviet government.”<sup>67</sup> Obviously, gaining possession and control of the hundreds of millions of dollars that had accumulated in state-owned hard currency accounts in domestic and foreign banks was much more attractive than the routine of extracting rents from newly emerging businesses.

An analysis of documents in the *Special Files* of the Politburo of the CPSU, as well as investigations conducted by the author and other journalists over the last decade, reveals at least four ways by which Soviet (and later, Russian) bureaucrats managed to acquire, and then make use of, financial resources they happened to control in the last years of the USSR.

The first way came into being in the mid 1980s, when the Soviet government abandoned its monopoly over international trade, and allowed twenty-one federal agencies, as well as specified enterprises, to engage in foreign trade. Managerial bureaucracy, particularly the directors of the oil, gas, timber, aluminum and other

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<sup>65</sup> Dr. Alexander Radygin, an academic from the Moscow based think tank Institute of the Economy in Transition and the country’s foremost expert on the development of private property in the USSR and Russia, claims that as many as 1000 associations of state enterprises were created under the patronage of the ministerial bureaucracy. The tragedy of those bureaucrats (which they never realized) was that they assumed that the enterprises and the goods they produced had value on the market, whereas they did not. That became clear much later, when the USSR opened its borders, and the inflow of western-made goods took over the domestic market, leaving little if any space for the domestic producers. (Alexander Radygin in an interview with Yevgenia Albats. Moscow, June 2001).

<sup>66</sup> In 1989, the Supreme Soviet of the USSR and the Council of Ministers of the USSR issued two executive orders, which were followed by the law allowing citizens to rent state property for the purpose of private gain. As a result, directors of the state enterprises were allowed to turn their plants into rented ones, while preserving managerial and financial control over the enterprises. Those laws allowed the directors to strip the assets of the enterprises, while making the state responsible for the well being (salary, social security, etc.) of the employees (Chubais, 2001).

<sup>67</sup> Mark Kramer, “Russia, the Demise of the Soviet Banking and Financial System, and the Collapse of the USSR” unpublished manuscript presented at the Davis Center for Russian and Eurasian Studies at Harvard & The International Economics Program of the University of Houston conference “Performance and Efficiency in the USSR: New Measurements and the Bergson Legacy” Cambridge, MA, November 24, 2003. In this paper Dr. Kramer described the idea of privatization of the Soviet banking and financial system in 1990 by bureaucrats of the government of the Russian Federation, which effectively led to the collapse of the USSR.

similar sorts of companies, stood to benefit the most from the privatization of export deals. Given the disparity between very low domestic prices and very high international prices for natural resources, such deals were extremely profitable: domestically, a liter of crude oil was priced the same as a liter of carbonated water, which of course meant that it was many times cheaper than the world price (Urinson, 1998). “That was the time when the first Soviet mega millionaires with houses and accounts in places like Cyprus came into being” a researcher of the subject told the author (Radygin, 2001). No wonder that the number of enterprises allowed to conduct foreign trade skyrocketed from 213 in 1988 to almost 20,000 in 1990 (Aslund, 1991: 141).<sup>68</sup> In addition to top-ranking officials from the oversight agencies and managerial bureaucrats, such deals were also beneficial to the gate keepers: bureaucrats in epaulets (the KGB, first and foremost) who controlled the borders and supervised, or served as middlemen, for deals outside the country. Thus, they were also able to share in the profits (Albats, 1994: 247).<sup>69</sup> “Borders were closed only for those who didn’t pay” a then-trader said in an interview (Kiselev, 2001).<sup>70</sup>

The second way of privatizing cash flows was performed via the creation of joint ventures with foreign firms usually associated with the communist parties of the respective countries, and thus named in the official CPSU documents as “friendly firms.”<sup>71</sup> Based on documents made available in the early 1990s, I compiled a list of 145 such firms, created through the 1980s on all continents and engaged in a variety of business activity, from publishing and retail apparel to oil trading. Of course, initially those firms were created to provide financial support to communist countries across the globe, but as the USSR began to crumble, they were used as a means of smuggling hard currency reserves out of the country. Even though few documents contain specifics, some do allow us to understand the means by which those cash operations were performed. For instance, one top secret document — a resolution of a Politburo meeting, addressed to the then Minister of Foreign Trade — directs that agency to sell approximately 600,000 tons of crude oil and 150,000 tons of diesel to the Italian company *Interexpo* at a price “1% less than its commercial value, so that after [reselling it] our friends can get approximately \$4 million.”<sup>72</sup> According to estimates made by the Procurator General’s office, which

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<sup>68</sup> Anders Aslund, *Gorbachev’s Struggle for Economic Reform*, Second ed. (Ithaca: Cornell University Press, 1991).

<sup>69</sup> Yevgenia Albats, *The State within a State: The KGB and Its Hold on Russia — Past, Present, and Future*, trans. Catherine Fitzpatrick (New York: Farrar, Straus, and Giroux, 1994).

<sup>70</sup> Oleg Kiselev, CEO of Impex Bank in the late 1980s, was one of those heavily involved in import/export deals. Interview with Yevgenia Albats, Moscow, July 2001.

<sup>71</sup> “On long-exceeded time limits on debts to firms of the friendly parties” memo by Valentin Falin, Head of the International Department of the Central Committee of the CPSU, to the Politburo; October 12, 1990.

<sup>72</sup> Protocol № 94, Resolution of the Politburo Meeting; January 18, 1983.

conducted a now sealed and classified investigation,<sup>73</sup> in the early 1990s as few as 300 and as many as 500 commercial enterprises were created outside the USSR by bureaucrats from party and state institutions over the course of the preceding decade.<sup>74</sup> There are no consistent estimates of the volume and size of operations in those firms. However, documents found in special safe boxes in the offices of former party officials, discovered after the collapse of the attempted coup in August of 1991, at least indicate the volume of cash available: \$14 million in ready money was discovered in just one office.<sup>75</sup>

Other means — such as foreign branches of the Soviet Gosbank — were used to channel party money to anonymous safe havens abroad. As one top secret 1990 party document states, “the world’s experience shows that this is the most mobile and reliable way of preserving property.”<sup>76</sup> For instance, an offshore financial management company, Co. Ltd (FIMACO), was created under the auspices of the Paris-based arm of the Soviet State Bank, Eurobank (the predecessor of the current Bank of Russia), located in the tax free Jersey Island of the British Crown. It was used as a safe haven for loans and credits granted to the Soviet government by foreign states.<sup>77</sup> In 1990, before “Desert Storm” the Persian Gulf states unanimously decided to grant credits to the USSR. Saudi Arabia, Kuwait and UAE gave collectively about \$1,75 billion (the Western press claimed that this was the price they paid for the USSR’s refusal to veto a resolution against Saddam Hussein in the UN Security Council). Some of the funds (\$250 million, according to well-informed sources in Vnesheconombank) were passed through Eurobank to FIMACO. There has been no trace of that money since.<sup>78</sup> Obviously, top-level party officials, bureaucrats from the KGB, the Ministry of the Foreign Affairs and various other financial agencies were the beneficiaries of this activity.

Finally, the fourth way of privatizing the nation’s financial resources was through investing money in the private domestic banks and businesses created by officials

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<sup>73</sup> Case № 18/6220-91 of the Office of the Procurator General, “On financial and commercial activities of the Central Committee of the CPSU” was investigated by 29 operatives and eleven special investigators until the end of 1993. Since then 200 volumes, which describe the case, have been classified as “top secret.”

<sup>74</sup> Andrei Illesh & Valeri Rudnev, “Poisk Deneg KPSS” (Pessimistic Ending: Search for the CPSU money ends in fiasco), *Izvestia*, national edition, 1 April 1994; Available at: <http://www.flb.ru/material.phtml?id=4910>.

<sup>75</sup> Ibid.

<sup>76</sup> KGB Colonel Leonid Veselovskii in his 1990 special memo to Nikolai Kruchina, then Head of the CC of the CPSU Directorate of Business Affairs.

<sup>77</sup> FIMACO was used in the same manner later by the Russian Government and the Russian Central Bank: at least \$ 2,5 billion of the nation’s hard-currency reserves, including some loans from the International Monetary Fund, found their way to the offshore company between 1992 and 1996. See Yevgenia Albats, Chernaya Kassa Strani (Black Cash Box of the Country), *Kommersant Daily*, 21 April 1999.

<sup>78</sup> Ibid.



from the party and state administrations. Such transactions became especially active beginning in 1990<sup>79</sup> and were directed by the Directorate of Business Affairs (the predecessor of the Kremlin's Directorate of the same name, which is responsible for the same activities and provides for the well being of the bureaucratic elite). As Sergei Aristov, one of the investigators who searched for the party money at the onset of liberal reform in Russia, stated, "while the majority of the country still lived under socialism, the Directorate of Business Affairs of the CC of the CPSU had already moved to the market economy and installed themselves there, where they had power."<sup>80</sup> Documents suggest that party officials created a wide variety of banks and businesses.<sup>81</sup> According to investigators, no less than \$ 2,5 billion was invested as start-up capital in approximately 100 banks and firms across the nation.<sup>82</sup> Other estimates suggest that Soviet bureaucrats successfully created as many as 600 to 1,000 firms in the final years of the Soviet regime.<sup>83</sup> Some even suggest that these large and successful businesses (which were later in the possession of the oligarchs) became the front-runners due to the infusion of the capital authorized by top-level Soviet bureaucrats. For example, the bank Menatep, which was registered in 1988 by Mikhail Khodorkovskii as the first ever commercial bank (and which later evolved into a conglomerate of companies, with the oil giant Yukos as its crowning jewel) was closely associated with the Directorate of Business Affairs of the CC of the CPSU. According to long-time insider Gennadii Razumovskii, a former member of the Politburo of the CC CPSU had been receiving a regular monthly payment from Yukos until at least 2001, though he was never an employee.<sup>84</sup>

I provide this list of facts and arguments in order to make two points.

The first point is that bureaucrats of the federal institutions of the former Soviet Union were busy acquiring control over the financial resources and assets of

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<sup>79</sup> In March 1990, the 3<sup>rd</sup> Congress of People's Deputies voted for the cancellation of Article 6 of the Constitution that held the CPSU monopoly. Among other things, it meant that the CPSU had to share its property with other parties and movements, which it did not intend to, at all. The then Head of the Department of the Central Committee's Directorate of Business Affairs, Nikolai Kruchina (who committed suicide under mysterious circumstances soon after the failed coup of 1991) became in charge of a campaign called "On urgent measures to organize the party's commercial and foreign economic activities."

<sup>80</sup> Agency of Federal Investigations, "Zoloto Partii — Desyt' Let Spustya" (Party Gold: Ten Years Later), *Moskovskie Novosti*, 8 May 2001.

<sup>81</sup> According just to one certificate "On deposits of funds from the account of the Department of the CPSU CC Business in other banks, associations, and enterprises in 1990–1991" some 22 existing or newly created banks and firms benefited from those deposits. For example, 1 billion rubles went to Autobank, 150 million to Tokobank, 200 million to Unikombank, etc. (Document from the archive of the Constitutional Court of the Russian Federation).

<sup>82</sup> Agency of Federal Investigations, 2001.

<sup>83</sup> Illesh & Rudnev, 1994.

<sup>84</sup> Viktor Ivanenko, retired KGB general and long-time Head of the Security Department of Yukos. Interview with Yevgenia Albats, Moscow, July 1998.

state-owned enterprises in the final years of the existence of the USSR, and they were investing this capital in pre-existing and newly formed businesses both inside and outside the country. Thus, their control aspirations were deferred for a while by those activities. This allowed small businesses to develop and flourish in the first years of the transition, reaching a peak in 1994 of approximately 897,000 officially registered small businesses (see Table 5).

The second point is that bureaucrats of the former USSR were engaged in market activities long before Yegor Gaidar and his government initiated economic reforms in Russia in 1992. Thus, the argument made by some theorists that the Soviet bureaucracy objected to proposed reforms (see Chapter 2 for a discussion of the issue) holds little weight. To the contrary, evidence suggests that the interests of the former Soviet elite coincided with the interests of the reformers; Soviet bureaucrats were not adverse to the market because they were in bad need of legitimizing their property rights, and thus had to be of only small concern to reformers during the initial phase of transition.<sup>85</sup>

### *1993–1998: Getting Back Control*

As described by one Russian liberal economist, 1993 was the year of yet another great bureaucratic revolution in Russia (Illarionov, 1997). Looking at the plethora and dynamics of licensing activity on the part of the bureaucracy, it is hard to disagree. It is obvious that bureaucrats exercised a free hand in acquiring control over the market field. By 1998, there were few business activities left that did not require a permit for start-up and/or additional ones to operate in the market. Consider the following example, which would seem like a *joke* if we did not know it to be true: at some point, businesses that operated resorts were required to obtain a license for measuring the temperature of the water in the sea, because, as the resort owners were told, “all oceanographic measurements are subject to regulation and require a license” (Tambovtsev, 2001b).

The course of Russian transition definitely reached a turning point in 1993. And so did the story of its bureaucrats. For one, 1993 signified the end of the govern-

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<sup>85</sup> In fact, I believe Yegor Gaidar realized the fact very soon: in 1992, the Russian government hired the New York based firm *Kroll Associates*, the risk consulting company known for its intelligence and investigative services, to search for the party money. Allegedly, the Russian government paid \$1,500,000 to the company for their services. However, the results of that investigation — if in fact it was ever really conducted and was not just a PR affair on the part of the reformers, — never became known. Moreover, none of the members of the first government are willing to discuss the subject even off-the-record. Logic suggests that by giving up on attempts to find several billion dollars of allegedly communist party money, reformers were buying themselves a peace pact with bureaucrats, hoping that the latter would use the acquired resources for the purpose of establishing a market in Russia. Roman Shleinkov, “Udavi I ‘Kroll’” *Novaya Gazeta*, № 41, 10 June 2002. Available from: <http://www.2002.novayagazeta.ru/numer/2002/41n/n41n-s08.shtml>.

ment of reform: in December of the previous year, Yegor Gaidar was replaced as prime minister by Viktor Chernomyrdin, a career Soviet apparatchik, whose appointment satisfied the aspirations of different groups from the former Soviet *nomenklatura* — i.e. managerial bureaucrats (who became known as “red directors”), state officeholders and the powerful energy lobby (Baturin et al., 2001).

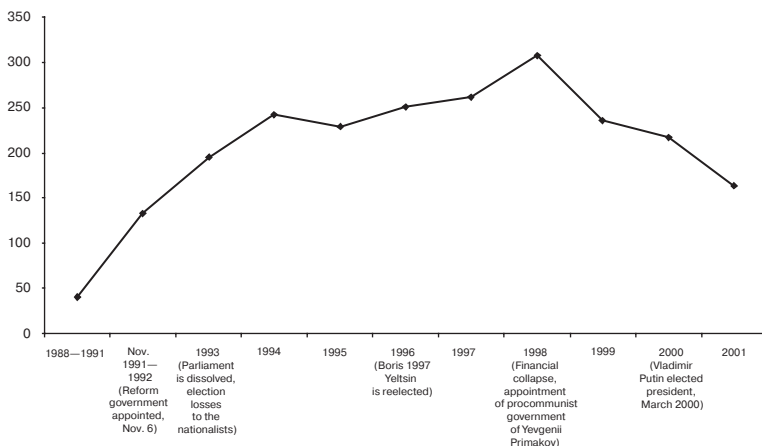
Chernomyrdin’s appointment inspired old career Soviet bureaucrats to seek office again. Galloping inflation, which was the key feature of the first years of reform (Aslund, 2002), ate much of the cash that they had grabbed earlier. Besides, experience of many acquired in the private sector was rather tough: many didn’t survive the competition. However, since no law precluded soviet bureaucrats from reacquiring their positions in top Soviet institutions, such as the Central Committee of the CPSU and the KGB, they became eager to get back into the safety net of state service. My analysis of the *spravochniki* (lists of employees by year) of the apparatus of the central administration shows that by 1995 the number of former elite apparatchiki of the Central Committee of the Communist Party quadrupled in the ranks of Chernomyrdin’s government compared to that of Yegor Gaidar’s government. Subsequently, the total number of bureaucrats in the apparatus doubled from 591 in the second half of 1992 to 1,189 in August 1995. We can safely infer that the trend was mimicked throughout the federal agencies. These new/old Soviet bureaucrats brought back the experience and methods they had acquired from their years in the Soviet regime, reintroducing regulation and control of the economy and of the public sphere in general. In the new market environment, that experience manifested itself in the issuance of hundreds of documents establishing control in the form of start-up and operating permits, certificates and the creation of bureaucratic businesses such as GUPs. Rents naturally came along.

In fairness to bureaucrats — although they may and do have their personal interests — they merely do what they are allowed to do by politicians. A profound political crisis that endangered the survival of President Boris Yeltsin himself also occurred in 1993. In September of that year, Yeltsin dissolved parliament, which refused to comply with the order. The situation evolved into a mini civil war in Moscow, ending with the bombardment and storming of the parliamentary palace (Colton and Hough, 1998: 6-7). That crisis brought about new parliamentary elections two months later, which delivered yet another blow to Yeltsin and reformers: the liberal party “Russia’s Choice” led by Yegor Gaidar, lost to LDPR, the extreme nationalist party of Vladimir Zhirinovski (Ibid.: 22). As a result, Yeltsin lost whatever beliefs he may have had about civil society and its role in Russian transition. “The events of that autumn and the outcome of the elections had a profound negative impact: further reforms were put on hold” Yegor Gaidar said in an interview with the author (Gaidar, 2000). “Yeltsin was frightened by that situation [unrest in Moscow and the loss in the elections], he was afraid of loosing control over the country, and he wanted the old Soviet bureaucracy to take over. And “it did” con-

firmed a long-time government and Kremlin insider from liberal economic circles (Pavlenko, 2001). Yeltsin had to give the old Soviet bureaucrats, perks and favors to make them loyal to him. Giving them a free hand to extract rents from the market via control over all kinds of permits was the way to satisfy them. As early writings acknowledge, “an important reason why many of these permits and regulations exist is probably to give officials the power to deny them and to collect bribes in return for providing the permits” (Shleifer and Vishny, 1993).<sup>86</sup>

Thus, the system of rents and permits did not arise simply because bureaucrats themselves were eager to expand their rent-extraction opportunities. Of course, they were. However, at least as importantly, it was because the political leadership of the country had made a choice in favor of the bureaucrats as their primary support base instead of the civil society that was then represented by small and mid-sized businesses. The following graph illustrates this conclusion.

**Figure 4.** *Dynamics of Licensing Activities and Political Events*



*As Figure 4 shows, the beginning of the licensing activities coincided with the unleash of entrepreneurial activities: apparently, some regulations were needed as it was stated in the previous pages. Reform government of Yegor Gaidar tried to play both the good and the bad cop: the ratio between promised benefits and those delivered was 1:4, e.g., approximately 20% of promises made to agencies came into being (Pavlenko, 1993b).<sup>87</sup> However, with Viktor Chernomyrdin, the career Soviet bureaucrat instituted as a prime minister, any constraints existed before disappeared and business of bureaucratic regulations flourished.*

<sup>86</sup> Andrei Shleifer and Robert Vishny, “Corruption.”

<sup>87</sup> Sergei Pavlenko, “Pravitelstvo Reform u Dotacionnogo Korita”, *Moskovskie Novosti*, 1993.

The decline in licensing activity, — which, oddly, occurred in conjunction with another election cycle, that of December 1999 to March 2000 — has several explanations. (To be sure — none of those explanations is in the realm of ideology. In that respect, government of Viktor Chernomyrdin was no more liberal than the government of Yevgenii Primakov who came into being after the August 1998 financial collapse, and which assumed leftist rhetoric and had some members of the Communist party of Russia at the key positions in the cabinet.)

First, the election cycle in question was a short period between two new laws on licensing — one passed in 1998 and the other in 2001 — which were aimed at constraining bureaucrats and reducing administrative corruption. It was the time when the new elite, which arrived with the newly elected President Vladimir Putin, had begun a battle with the old elite, which remained from the presidency of Boris Yeltsin. (In a country dominated by bureaucracy, a fight between elite clans within it is always helpful to outsiders: they are finally left alone, even if for a short while.) As a result of this “healthy” battle inside and among bureaucratic agencies, some who were closely associated with the Yeltsin regime lost their privileges. For instance, Gosatomnadzor, the oversight arm of the Ministry of Atomic Energy, held the rights to issue as many as 400 permits before 2001. However after its head was dismissed by the new president, that number was halved (Auzan, 2001). By comparison, agencies associated with issues of national security, defense and political police, by virtue of having a KGB colonel as President, managed to preserve and in certain cases even increase their rights of control. However, I believe there is also another reason for the decline: oil prices. By 1999, oil prices began to rise, which was something that Russia had last experienced in the 1970s and early 1980s. Thus, bureaucrats from the new elite were more preoccupied with acquiring control over oil and gas, rather than dealing with small and mid-sized businesses that, in any case, were half dead.

### **3. Small Business: Dead Men Walking**

Given the scale of bureaucratic control, it is no surprise that 1994 was the last year that statistics acknowledged a growth in the number of small businesses. Thereafter, there was never so high a number of registered small businesses operating in the legal — as opposed to gray, unofficial — economy.

I decided to conduct a statistical test to check the relationship between the licensing activity of bureaucrats and the decline in the number of small businesses. The simple correlation between the number of small businesses over the period of ten years (1991—2001) and the number of licenses issued over the same period

appeared to be strong and significant ( $R = .849$ ,  $p < 0.01$  level), but the conclusion that follows out of the result was that licensing greatly promotes creation of small businesses. That contradicts both the common sense and the qualitative analysis, and suggests that outburst of business activity went along with licensing activities. To put it in plain English, the initial spur of small businesses in early 1990s was due to the “opening of the gates” effect, e.g., that many of these businesses had been operating in the unofficial economy during the final years of the USSR, and so were “newly legal” rather than “newly established;” besides that permission to conduct entrepreneurial activities gave an exit option to many those young and energetic Soviet people who were unable anymore to tolerate the boredom of the Soviet enterprises and institutions: regardless of restrictions they were eager to start a new. Thus, it makes sense to disregard these first years of “business and social optimism” and to look at the correlation between the number of licenses at time  $t$  and the number of small businesses at time  $t + 1$ . The correlation between the one year lag of the number of licenses and the number of small businesses is lower, but nonetheless positive and significant (Pearson  $R = .778$ ,  $p < 0.01$ ). After the initial spur in small business development (1991–1993), licenses, as it was predicted by the qualitative analysis, indeed seem to harm small businesses. The negative correlation ( $R = -.205$ ,  $p < .596$ ) suggests that the increase in the number of licenses is associated with a decrease in the number of small businesses. However, the correlation is not significant, so we cannot be too certain about it. In order to overcome the problem, we decided to create a new variable (LICECHNG) which records whether the license burden increases or decreases from year to year.<sup>88</sup> This regression shows that a decrease in the number of licenses leads to an increase in the number of small businesses (see Table 8). The relationship is not too strong, but we could be at least 86% confident that this relationship does exist. The results suggest that each additional license may lead to the disappearance of 941 small businesses nationwide (in the regression small businesses are counted in thousands, therefore, the number in the table is .941). We can be also 80% confident that anywhere from 97 to 1,780 small businesses are affected by issuing just one additional license. Our uncertainty is obviously the result of the small number of observations (just over ten years), but we can state that at least the fifth of the variation in the number of small businesses nationwide can be explained by licensing activities

There are of course other factors, but licensing has had an impact on the decrease of small businesses. The impact of GUPs, system of certification, myriad of controllers have been presented earlier in the chapter. The existence of state monopolies and large oligarchic businesses that enjoy special treatment from the state is also important: they deprive the free market of its most important characteristic — com-

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<sup>88</sup> To compute the individual observations the number of licenses in each year was subtracted from the number of licenses in the subsequent year. For example, in 1992 there were 77 more licenses than in 1991, so the value for LICECHNG for 1992 is +77.

**Table 8.** *OLS Model of the Relationship between Licensing and the Number of Small Businesses*

Independent Variables	OLS coefficients and 80% confidence intervals
Constant	855,465 (812,597; 898,333)
Change in number of licenses from previous year (LICENCHNG)	-941(-1,784; -097)
R <sup>2</sup> =.23, N=10, p<.16	

petition (EBRD, 2003). Small business has always been treated as unwelcome child by its foster parents, the federal government. Instead of easing the burden on start-ups, the government of Viktor Chernomyrdin for instance, consistently did the exact opposite. For example, in 1995 the government changed the definition of small business, lowering the number of employees that satisfied the definition from 200 to 100 people. That measure alone effectively stripped thousands of businesses of tax exemptions they had had under the old definition of small business (Kuznetsov, 2001).<sup>89</sup> The pro-Communist government of Yevgenii Primakov, which came into power in autumn 1998 following the financial collapse, continued down the same path: it eliminated the State Committee for Support of Small Businesses et al.

Thus, in one way or another, bureaucrats not just ensured their control over business, but by reducing the number of small businesses, have made that control more efficient. For whatever it is ultimately worth, it was a smart move on their part. After all, small business as a basis for civil society poses a potential danger to bureaucrats. Should such businesses happen to be successful — as they are in the countries of Central and Southern Europe — they would become the driving force of civil society and, by extension, a political force capable of demanding accountability and transparency of the government. Absence of that force further unties the hands of bureaucrats.

## Conclusion

Bureaucrats are not devils. On the contrary, their behavior in post-communist Russia is very rational. Democratic politics, with its demands for accountability, is a threat to their survival and well-being. Thus, even at the expense of losing some rents (and with the hope of filling the void with big business and oil profits), through the decade of economic transition, they have consistently exercised increasing pressure over small business — which, as I argue in my model, is the biggest consumer of democratic politics in post-communist states, as well as the biggest resource of the potential social capital in countries in transition.

<sup>89</sup> Pavel Kuznetsov, Deputy to the Head of the Working Center of Economic Reforms under the Government of the RF. Interview with Yevgenia Albats, June 2001.

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