

# Informal Practices in the Russian Private Sector

**Alena Ledeneva and Eugene Nivorozhkin**

In the 1990s, Russia's development emphasized reforming formal institutions. Yet the outcome of these reforms often depended on informal practices that both opposed and contributed to formal structures. These informal practices moderated some of the exigencies of transition, helping companies to exploit legal loopholes and optimize tax schemes. However, they also allowed companies to engage in asset stripping, share dilution, and transfer pricing, not to mention the limitation of shareholder voting rights and the abuse of Russia's insolvency laws. While the Russian economy of today is much more stable and prosperous than it was 10 years ago, Russian businesses continue to require a high degree of informality to 'get things done'. Informal practices persist because interpersonal trust compensates for popular distrust of state and financial institutions.

## Informality and Russia's economic transition

Informality is commonly associated with corruption and the absence of the rule of law; it is believed to subvert the foundations of good governance and investor confidence. Informality certainly allows competent players of informal rules to bend the system to their advantage. What is rarely noticed, however, is that these practices played a key role in transforming Soviet enterprises into private businesses able to compete in a market environment. For example, Adachi underscores the importance of informal corporate governance practices in three major Russian companies—the oil company Yukos, Russian Aluminium and Norilsk Nickel—in their struggle to survive, to deal with the disintegration of the Soviet economic system, and to compete and grow under post-Soviet constraints (Adachi 2005). In *How Russia Really Works* (Ledeneva 2006), informal practices associated with barter, financial schemes, and alternative contract

enforcement mechanisms are shown to have both advanced business and strengthened the importance of non-market alliances, which are both competitive and anti-competitive.

While informal practices rapidly adapt to legal changes and make use of legal institutions, they also create obstacles to consolidating the rule of law. Although primarily benefiting certain groups, informality caters to a wider set of economic needs and is implicitly endorsed by the state. The state itself is sometimes accused of 'tax terrorism' against business. Hainsworth and Tompson (2002) refer to 'the informal fiscal system' that reflects official responses to short-term financial and political pressures. Part of the problem is the lack of clear, accessible, and consistent rules. Thus, contradictions in tax legislation virtually guarantee a degree of informality, since officials must decide which rules to enforce and when. The tax organs sustain non-transparency by devising enabling regulations that allow them to manipulate inconvenient legislation. Vested interests in state agencies lead to informal 'bargaining' between taxpayers and officials at all levels. The formal rules of the game—tax legislation, normative acts, ministerial instructions—are important factors in these negotiations, but they are not definitive.



*Firms often resort to paying in cash to avoid taxation*

© Mikkel Ostergaard / PANOS PICTURES

The relationship between taxpayer and tax collector is not normally based on negotiation, but in Russia, as Hainsworth and Tompson indicate, 'The bargained tax bill is no more a paradox than was the bargained plan'. Unlike the use of black cash or bribery, many tax schemes are grounded in legal loopholes and can be more properly described as tax avoidance than tax evasion. They exploit defects in the tax legislation which, according to some respondents, may have been left there on purpose. The centrality of law in such creative scheming, however, is a noticeable and positive development.

## The key role of Russian banks

Russian banks tend to play a dual role vis-à-vis the tax organs—they are both taxpayers to, and agents of, the fiscal organs. Since a substantial share of tax revenues is collected via the payments system, tax authorities rely heavily on banks not only to provide information about clients' finances, but also to cooperate in tax collection. This practice creates an incentive for firms to conduct transactions in cash. However, the use of black-cash strategies by firms is limited, and typically requires the banks' help in obtaining large quantities of cash in violation of restrictions on the use of cash for inter-company transactions. Hence, banks play a critical role in so-called 'tax optimization' strategies.

The centrality of banks in managing financial flows and information, and in mediating between tax collectors and tax payers, allows them to create and exploit these profitable lines of business. Russia's Central Bank fell under intense scrutiny following the murder of Andrei Kozlov, its first Deputy Chairman, in September 2006. There are widespread concerns that Central Bank decisions concerning small- and medium-sized banks are overly subjective and often politically motivated.

Trust-based relationships are also the basis for insider trading, which (given the few legal restrictions on it)

seems widespread on Russian financial markets. While the law 'On Securities Markets' prohibits trading based on 'office information', its definition is vague and penalties for its use are insufficient. The notion of 'insider information' is not used, and the Federal Service for Financial Markets (FSFM) has insufficient powers to deal with it. A draft of the law on 'insider information' was prepared by the FSFM in 2005; it remains under discussion. Whether its eventual enactment will reduce the scale of insider trading and price manipulation remains to be seen.

It is often assumed that informal practices in Russian business are a Soviet phenomenon and thus are less common today. Our research and recent events in the banking sector dispel this myth. Informal practices, in particular those associated with discrete banking services, are reported to be essential for business operations and indicative of the importance of interpersonal trust in Russian business (Ledeneva 2006). The prime break with the Soviet past has taken place in relation to the poor. Informal practices in today's Russia are much more exclusive and do not cater to their needs.

Alena Ledeneva is Reader in Russian Politics and Society, and Eugene Nivorozhkin is Lecturer in the Economics of Central and Eastern Europe, at University College London.

## References:

- Adachi, Yuko. 2005. *Informal Corporate Governance Practices in Russia in the 1990s: The cases of Yukos Oil, Siberian (Russian) Aluminium, and Norilsk Nickel*. PhD dissertation, University College London.
- Hainsworth, Richard and William Tompson, 'Tax Policy and Tax Administration in Russia: The Case of the Banking Sector', *Post-Communist Economies*, Volume 14 Issue 3, September 2002.
- Ledeneva, Alena (2006). *How Russia Really Works: The Informal Practices That Shaped the Post-Soviet Politics and Business*. Ithaca: Cornell University Press.