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# Historical Overview

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**PART 2**  
**HISTORICAL OVERVIEW**

## 1 UNDERSTANDING RUSSIA

### Maxim Storchevoy and Jeffrey Hass:

The goal of this chapter is to discuss key values and archetypes of Russian culture that have developed over several centuries of Russian history. This fundamental introduction is important because these values and archetypes have successfully manifested themselves through various institutions of the Russian Empire, the Soviet Union and post-Soviet Russia. What are they and what are their roots? Answers to these questions can help us better understand Russian economic and business culture that shapes the behaviour of entrepreneurs, investors and employees in the current economy, and also political and legal traditions that play enormous roles in establishing and running a new enterprise in contemporary Russia. In particular, the state will play an important role in our narrative; indeed, in Russia, one cannot talk about business without talking about the state. Evolution of property rights and economic freedoms, risks and advantages of state interventions in the market economy and relationships with local authorities or regulatory bodies, including legendary issues of “autocracy” and “corruption”, have enormous importance for business in Russia.

### 1.1 Between Vikings and Mongols

The known history of **Rus** (i.e. the name of early Russia) starts later than histories of other major European countries. By itself, this fact cannot explain the disappointing backwardness Russia systematically experienced along its historical path. However, coupled with other important factors such as geographical location, size, climate and the unfavourable influence of predatory nomads, this might help us understand some crucial components of later Russia; for example, the autocratic political system or extensive character of the economy.

As often happens, the fate of a young and less-developed society might be shaped by a stronger neighbour, perhaps an empire with Roman law or a barbarian dictator with primitive culture. Early Rus was a forest territory populated by scattered agricultural tribes and located between Europe and Asia. Thus, it was a subject of potential interest for more powerful and better organised forces from both geographic sides. It happened that both were influential in various periods although, politically, the Asian side had earlier and longer-lasting consequences.

The initial influence came from Europe. Historians believe that the Rus state was founded in the 9<sup>th</sup> century by Swedish Vikings attracted by water routes to Byzantium and the Near East (i.e. from the Baltic Sea, through rivers to the Black and Caspian seas)<sup>6</sup>. As Muslim conquerors disrupted direct trade between Europe and the Middle East in the 7<sup>th</sup> and 8<sup>th</sup> centuries, alternative routes had crucial business importance. The Vikings were not interested in the land itself because the climate was not favourable for agriculture and the native people easily migrated. They collected some tribute from locals but their main interest was trade. Thus, the Vikings built many cities along rivers, the most important of which was Kiev – the last large trading hub on the way to

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<sup>6</sup>However, one should be careful mentioning this when talking with contemporary Russians, as it is a sensitive point in the official history. Official historians traditionally present another version in textbooks: Russian tribes *invited* two Scandinavian knights to rule the country.

Byzantium. Over time, Vikings married local women and assimilated. It is important to note that it was not the Vikings who brought the tradition of autocracy to Russia, as they did not aim to exercise total political power over the territory. For example, cities were managed with the help of **veche**, a people's meeting at the centre of the city.

Viking commerce was undermined at the end of the 12<sup>th</sup> century when the Pechenegs, a semi-nomadic Turkic people of the Central Asian steppes, made trade routes between Kiev and Constantinople extremely insecure. This forced Russian princes to turn to agriculture. In turn, the northern part of Rus gained some advantage because of its remoteness from hostile nomads and the centre of power began moving to the North.

The Russian state could have followed the European path of development, with incremental progress in private property, parliament and so on. Unfortunately, this path was deflected by the **Mongol invasion** of 1237-1242. Mongol nomads conquered almost all Russian lands and they could have moved further into Europe if internal political problems in their own state, the Golden Horde, had not forced them to turn back. Formally, they did not append Russian territories to the Golden Horde because it was too remote for direct administration. Instead, they imposed a high annual tribute on the Russian people. At first, the tribute was collected by Mongol representatives, but this practice soon led to local conflicts and, after a decade, the function of tax collection passed to Russian princes. Any prince succeeding his predecessor had to visit the Golden Horde to obtain a seal of approval for ruling and collecting duties for the Horde. However, at the beginning of the 13<sup>th</sup> century, tribute collection was centralised when the prince of Vladimir agreed to collect the duty from all princedoms, for which he was bestowed the title of Grand Prince. This change had an enormous impact on the political culture of Russians as the Grand Prince relied on the military force of the Horde to levy and collect taxes. Another factor was that, as some historians claim, the sons of grand princes were held as hostages in the Golden Horde to ensure their fathers' loyalty and, in the process, these sons learned first-hand the Mongols' administrative practices. When returning to their homelands, they brought with them patterns of Mongol administration.

The influence of Mongol rule on Russian economic and political culture was quite extensive. For example, in terms of language, the common Russian words for money (*denga*), market (*bazar*), and profit (*barysh*) derive from Turkic languages and were introduced by merchants who travelled to the Golden Horde.

## 1.2 Autocracy: from Tsar to President

As the Mongols' control waned in the early 15<sup>th</sup> century, the Grand Princes of Rus decided to take over their function and rule the country in the same way: keeping all princedoms together, collecting taxes and suppressing disagreement with armed force. As a result, the Russian state developed into an **autocracy** with strong central power and relatively powerless provinces.

Development of the autocratic state took some time, during which local property or political rights were gradually replaced with centralised control. For example, Novgorod and Pskov avoided the Mongol invasion and consequently preserved their *veche* and traditions of electing rulers whose powers were circumscribed by a social contract. This legacy was destroyed during the wave of cruel repression by Ivan the Terrible (1553-1584), whose rule was brutal (literally, a predecessor to Stalin) and who

established a special military guard (*oprichnina*) that was above the law and could repress dissenting nobles and ordinary people.

One factor in the formation of Russian autocracy was the fall of Byzantium in 1543 and the decision of Russian princes, in collaboration with the Russian Orthodox Church, to proclaim Muscovy as the successor to Byzantium – the Third Rome. Afterwards, the Grand Prince of Moscow was increasingly referred to as **tsar**, the traditional title of emperors of Byzantium. The tsar's power was worshiped in Russia as sacred and the Russian people gradually developed an unconditional belief in a “good” tsar and obedience to governmental actions.

Tsarist autocracy was successfully sustained for the next three centuries. However, in the 19<sup>th</sup> century, it became increasingly clear that this political structure, in combination with serfdom, was obsolete and even immoral and should be reformed or even dismantled. The most progressive circles risked protest but had little success. In 1825, the Decembrists' revolt and demand for constitutional reform was suppressed; fifty years of reaction followed. In the 1860s, tsar Alexander II was ready to announce constitutional reforms but he was killed by revolutionary terrorists. This led to further reaction and froze the system for another fifty years, until the tsarist autocracy collapsed during World War I and Vladimir Lenin and the Bolsheviks took power.

Lenin and his party initiated a large scale experiment aimed at building a new socialist society that, in theory, would be democratic, free from exploitation and economically efficient. The bitter irony was that real **Soviet society** inherited many traditional traits of tsarist Russia. The most important was the autocratic political system with a worshiped leader. Lenin was intolerant of dissent, but after his death in 1924 and a few years of elite struggle, Joseph **Stalin** appropriated all political power and initiated organised terror against his opponents, real or imagined. Dissent in nearly any form was persecuted with the help of a new security service that would later become the KGB. The new Soviet society was based on deep belief in the sacred nature of central authority, usually typical of theocratic states. After Stalin's death, his successors stopped mass repressions but maintained the leading and undisputed role of the Communist Party until the last days of the USSR.

Meanwhile, as had happened in the 19<sup>th</sup> century with tsarism, by the 1980s it became apparent that the Soviet system was ineffective and required reforms. After a period of political instability, the Soviet Union was dismantled and the new Russia had its first democratically elected president, **Boris Yeltsin**. Yeltsin supported liberal and democratic values, but in his last years in office he was increasingly manipulated by his close circle of advisors who were interested more in maintaining power and privileges. Eventually, health problems forced Yeltsin to step down and make way for a “successor” – the relatively unknown Vladimir Putin who, it was thought, would continue Yeltsin's general line. However, before long, Putin changed the political orientation of the Russian state: he reined in the media under state control, increasingly excluded opponents from the political arena and restored a modicum of autocratic rule that included traditional exaltation of the leader, persecution of threatening opponents and prohibition of significant criticism. The only difference from the tsarist autocracy was that now the “tsar” was titled “president” and would be elected “democratically” by manipulated voting. Again, Russian autocracy prevailed. Was this inevitable? What are the real roots of such fairly consistent political structures? These questions remain open.

### 1.3 “Great Russia” and National Pride

Ask an average Russian why he or she is proud of their motherland and they will say that they live in a great country – large, strong, a winner of wars. This position of Russia as a “great power” was first proclaimed by tsar **Peter the Great** at the beginning of the 18<sup>th</sup> century. Russia faced strong foreign challenges and could have lost its northern territories to Sweden and western territories to Poland and, thus, been reduced to a small Muscovite state with archaic political and economic systems, isolated from access to ocean routes and having little significance on the international scene. This did not happen because Peter the Great was enormously energetic, decisive and passionate. In 1697–98, when travelling in several European countries, Peter was impressed by modern technologies and institutions. On his return to Russia, Peter launched a great westernisation project, importing into Russia much technological and administrative knowledge. However, this was modernisation “from above” based on authoritarian methods of governing, suppressing all significant dissent and accumulating enormous power in the state. Eventually, Peter’s reforms achieved their purpose. After twenty years of confrontation with Sweden during the Great Northern War (1700-1721) for the eastern Baltic region, Russia triumphed and emerged as another great European power. Since Peter, Russian tsars titled themselves “emperors” and Russia continued to play the role of a “great power” and expanded its frontiers, although never being able to modernise its political and economic systems. Catherine the Great (1762-1796) won another war with Sweden, took some territory from Poland, defeated Turkey twice and expanded Russia’s borders to the Black Sea. Later, Russia won other large scale wars to solidify its “great power” status; in particular, victory in the Napoleonic wars of 1812-1813. In the 19<sup>th</sup> century this position gradually eroded due to political and economic backwardness, culminating in the Russian Revolution of 1917. However, the country rebounded when the Soviet Red Army defeated Nazi Germany in World War II (1941-45), emerging as one of two “superpowers” in a cold war, nuclear arms race and space race with the United States (1950s-1980s).

All of these “glorious” facts were always emphasised in official propaganda and school textbooks of the USSR and later in the Russian Federation to promote the idea of “great Russia” and to distract popular attention from other areas of poorer achievements, especially quality of life, and to persuade the people to suffer additional troubles for the sake of the great country. This belief in Russian “superiority” is still shared by many Russians and can assume messianic form.

### 1.4 Always Limited Rights

An important condition for good business development is **property rights** that are well defined and protected by law. This enhances incentives for people to care about their assets and to invest in their development, a great driver of economic growth. In Britain, private property in land had existed in the 7<sup>th</sup> century AD and was decisively reaffirmed in the 17<sup>th</sup> century during the confrontation between the king and nobility. Well-defined property rights also created a middle class that was crucial to the development of parliamentary control over the monarchy and eventual democracy. Unfortunately, Russia did not develop such rights. When Eastern Slavs entered the forests of future Russia, land rights were of no importance. Land was in such abundance that there was no need to consider its long-term efficient usage. Slavs practiced slash-and-burn agriculture, whereby farmers cut and burned forest sites and exploited this land for several years until the soil was exhausted, at which point they moved to new land.

When Slavs turned to settled farming, they inevitably had to pay tribute to a local knight; although this was less a rent than a tax or “protection payment.” While peasant communities did develop systems of governing land use (which we discuss below), these were not rights to “property” that were recognised by a local knight or prince. As in many other countries, Rus developed a system of military land tenure whereby every territory had to “feed” a knight who provided military service to the Grand Prince, who in turn supported the knight’s “right” to collect tribute from the respective territory.

In the same period, peasants were also gradually losing personal freedom. The abundance of land in Russia meant peasants could always migrate to another landlord or even into ungoverned territory. This is why owning land made little sense in Russia. Only land with people could have value. At first, Russian peasants might freely migrate from one land owner to another, although there was a custom limiting migration to two weeks after the completion of the agricultural season in November. However, after the middle of the 15<sup>th</sup> century, the right to migrate was abolished for several reasons. The growth of peasants’ duties caused by wars or bad harvests led to increased migration in search of easier living conditions. As a result, Russian landlords persuaded the tsar to introduce **serfdom**, by which peasants became linked to the land where they lived and could not migrate without their landlord’s permission. This was a system of semi-slavery, as peasants could be sold with the land, similar to cattle or buildings. As a result, Russian peasants lost the last right they possessed, the freedom to move at will.

The tsar was the only truly free person in Russia. All other classes (i.e. landowners, peasants, townsmen and priests) had few, if any, inherent personal freedoms and property rights. Landlords and their older sons had to be on active military duty or at least be ready for immediate duty. The tsar was the ultimate owner of all land and could deprive any landlord of his possessions.

With time, this system degraded and lost its efficiency. At the beginning of the 18<sup>th</sup> century, Peter the Great introduced a professional army and landlords or their elder sons initially had to serve as officers. However, in two to three generations after Peter, this military duty was gradually abolished, although corresponding land-holding rights remained unchanged. This was a paradox: peasants were enlisted to enable landlords to provide a military service; however, the abolition of obligatory military service did lead to the abolition of serfdom. Peasants remained serfs and their rights and duties continuously deteriorated. They could not sign contracts or documents, could be sold at the serf market or sent to Siberia at the will of their landlords. Moreover, serfdom undermined the development of capitalism due to cheap compulsory labour. Theoretically, emerging entrepreneurs could lease serfs from their landlords, but they could not compete with products of landlord workshops that employed free enlisted peasant labour. This is why the number of entrepreneurs in Russia remained small and cities remained administrative centres. In the 19<sup>th</sup> century, this serfdom trap and also autocracy was recognised by many as a key problem. In 1861, Alexander II issued a decree dismantling serfdom, although peasants had to pay for their freedom and were not granted any land. Thus, until the beginning of the 20<sup>th</sup> century, little effectively changed for the majority of peasants.

Private property in commerce and manufacturing developed with similar limitations. Russian merchants or manufactures could be asked by the tsar at any moment to provide money or services for state needs.

When the Bolsheviks came to power in 1917, they immediately declared that all land belonged to the peasants. However, after several years it became clear that the position

of the latter would only get worse. After some early experiments, the Bolsheviks imposed compulsory collectivisation: the creation of collective farms (*kolkhoz*) where all peasants had to work together and have common ownership of all tools, livestock and land. Much of their produce was expropriated by the state for industrialisation. Russian peasants again lost freedoms and had to work as serfs for another 50 years. More or less, this was the fate of all Russians. Private property was abolished; factories and enterprises were now owned by the state, which became the single employer for the whole economy. All other freedoms (e.g. freedom of speech, assembly and movement) were also severely curtailed. Those who disagreed could be treated as “enemies of the people” and executed. Migration abroad was generally prohibited.

In the second half of the 1980s, Mikhail Gorbachev introduced reforms that provided freedom of entrepreneurship and embryonic property rights. Millions of Russians could own, invest and manage; as thousands exercised these rights, a new market economy began to form. However, it was no surprise when, in a country with no real traditions of private property and entrepreneurship, the first entrepreneurs faced serious problems with the normal exercise of their rights. In the 1990s, the most serious issue was the problem of security. Alongside normal entrepreneurs were “criminal entrepreneurs” (i.e. gangsters) who profited from selling “security”. The traditional Soviet police (*militia*) did little to address this problem and soon virtually all entrepreneurs had to pay some protection money to an organised gang (*krysha*). In the 2000s, all “kryshas” migrated into legal security firms or infiltrated the police and the market for protection became more civilised. However, property rights of new entrepreneurs and business people in modern Russia remained conditional. Primarily, they had to be loyal to the authorities. Any entrepreneur who showed some support for opposition elites could lose his/her property, as happened to Mikhail Khodorkovskii in 2003. Moreover, in the 2000s, many enterprises became victims of so-called raiders (i.e. hostile takeovers), when a “raider” company would employ some fictitious legal reason (e.g. unpaid debts, violated license or regulation) to take over the assets of a target company, often with help from local or federal officials. This has hurt the confidence of Russian business people and led to periodic capital flight from Russian markets.

Therefore, *private property and other freedoms in Russia always seem limited by the state and various criminal actors*. Explaining the surprising stability of this trend is no easier than explaining that of autocracy.

### 1.5 Bureaucracy and Its Principles

There is a saying that “Russia is owned and ruled by bureaucrats” and both Russian tsars and modern presidents had equally limited opportunities to manipulate this social class. Is this true and, if so, and why?

Active growth of the bureaucracy began under Peter the Great and was part of the modernisation process. Peter tried to build one large command economy and to regulate all state activities through a **system of departments and ministries**. As the state apparatus increased enormously, Peter had to introduce new codes for civil servants and introduce a new system of social stratification, the *Table of Ranks*, in which the status of an official was based on years and performance in state service. Before Peter, civil servants often were paid little, which led to a system of “feeding”, whereby officials took some payments in cash or in kind from people for services rendered. Peter ended this system and decreed that all officials would receive a fixed salary from the state budget. After Peter, this system began to degrade. Sometimes

there was insufficient money for salaries and new tsars allowed a return to the old “feeding” system. In the 19<sup>th</sup> century feeding was again prohibited, but as the government salary was delayed or paid in depreciated paper currency, officials continued to take bribes.

Usual forms of corruption in Tsarist Russia involved **bribes** for taking some action (e.g. giving a permit) or refraining from others (e.g. not noticing legal violations) and taking illegal rewards for allocating state procurement contracts. The latter was especially prevalent during military campaigns when the state significantly expanded procurements. Almost every Russian war was accompanied by many scandals connected to procurement.

The Soviet bureaucracy played an even more important role in social life because the entire economy was centrally administered. The number and importance of civil servants significantly grew. If, in 1913, the number of civil servants was approximately 1.6 per 1,000 people, in the 1920s this figure was nearer to seven. However, the efficiency of their work was quite low. It seems that this administrative mechanism worked sufficiently well during World War II, when the entire country was mobilised to defeat Germany. It worked comparatively well in the decade that followed the war due to large-scale popular enthusiasm for rebuilding the country and building a new, prosperous society. However, by the 1970s, it was clear that this bureaucracy was far from efficient. Bureaucrats had few incentives to work well and their moral qualities deteriorated. The only real way to improve their personal welfare was to take bribes or steal, which they did as much as possible. Top Soviet authorities were still committed to ideology and generally were not corrupt. They even tried to fight state corruption, but officials were quite careful in their shadow economy activities and such campaigns had no real effect.

After the collapse of the USSR, it seemed that unlimited bureaucratic rule had ended and that the country could create a market economy with minimal state apparatus. Paradoxically, this was not to be. Under Boris Yeltsin, the bureaucracy continued to grow and it expanded even more under Putin’s presidency. If, in 2000, the number of bureaucrats in Russia exceeded 1.1 million (i.e. almost 15 per 1,000), in 2010 it was already 1.6 million (i.e. 25 per 1,000), although Putin annually declared the need to streamline the state apparatus. At the same time, the amount of corruption increased enormously. According to various estimates, from 20% to 60% of the state budget is embezzled in various ways by state officials.

How to explain this paradox? There is only one explanation: the central authority in Russia has always depended on the loyalty of its bureaucrats. A president or a prime minister can proclaim any anti-corruption campaign and reduction of state apparatus but, in reality, the head of every ministry or state department is interested in expanding its budget and apparatus and in providing support for the authorities in exchange for new budgets and informal permission to enrich themselves without apparent violation of formal laws. As is often mentioned by analysts, Russian corruption is not a problem but a method of public administration.

The downside to this system is that Russian bureaucrats usually do not feel any responsibility towards ordinary people and do not show them much respect. Traditionally, it is difficult to utilise the Russian system of state services. To access some service, one needs to spend much time waiting, with the high probability of being treated in an impolite manner. All questions are addressed slowly and inefficiently, which is not simply a result of general inefficiency but also part of a strategy to make

people pay bribes for faster solutions. As a result, Russians have never liked civil servants and bureaucrats have been important objects of hate for Russian people for centuries. Indeed, over time, the majority of Russian bureaucrats developed their own special caste, spending their lives in their offices serving and being fully dependent on the state and thinking that the state is the most powerful and important thing in society. Many bureaucrats, especially those with high ranks, help their children enter their profession in good positions and consequently the bureaucracy has a hereditary component, socialising particular values from birth. Among these bureaucratic values we usually find unconditional loyalty to the highest authorities (i.e. tsar or president), belief in the primary role of the state in national development, belief in the necessity of a “great Russia”, especially among military and diplomatic bureaucrats, and a complete misunderstanding on market competition or democracy.

Ironically, in the Putin era, the enrichment and status of bureaucrats became so obvious to the public that surveys revealed that the most popular profession among teenagers was the civil service; educational programs in public administration were inundated by applications from potential students.

### 1.6 Collectivism vs. Individualism

Another aspect of Russian history and culture is the common belief in a special **collectivist spirit** that makes Russians prefer collective action, common responsibility and egalitarian distribution of income. This is often employed to support such concepts as “incompatibility of Russia and a market economy,” a special “socialist spirit of Russia,” the statist idea of the state’s key role and even the missionary idea of “Great Russia” requiring sacrifices for a higher common goal. The hypothesis of a special collectivist spirit has some grounding in Russian history with some exceptions.

There was an important element in the traditional peasant economy that had an enormous impact on Russian political culture: the rural **commune**, or *obshchina*, an organisation of all families in one village responsible for collective governance of land usage and collective provision of annual duties (i.e. in labour or in kind) to landlords and the state. Collective tax responsibility was established by landlords because it was easier to count people in a village and to impose a gross tax payment for the whole village. Consequently, peasants started to consider village land a common resource that should be utilised to fulfil collective duties to landowners and the state. Every two to three years, the *obshchina* redistributed farming land between families according to the changing number of working hands in each family and the comparative land quality. The purpose of this redistribution were considerations of justice and efficiency as each family was to have enough land for efficient labour and to contribute to the collective pool of duty. As the number of working hands changed from year to year (e.g. deaths, births, marriages and migration), the distribution of farming land was adjusted correspondingly. If a family could not make its contribution to the collective duty the residual duty was shared between all other families, thus leading to joint tax responsibility. An important consequence of this system was the absence of any significant wealth differentiation among Russian peasants. Indeed, the Russian agricultural commune and joint tax liability were the main factors preventing development of capitalist agricultural farmers and the spirit of individualism and entrepreneurship among Russian people.

A similar institution, the *artel*, existed among other professions; for example, fishing, mining and even thieves and beggars. It was a cooperative association of people in one

profession who worked together and normally redistributed earned income among all members of the group. There were several reasons for this. First, this association was utilised in areas where a customer needed several workers to perform a task; for example, construction or loading cargo. In this case, it was easier for the customer to have an agreement with one responsible person, the head of the *artel*, instead of hiring all workers on an individual basis. *Artel* members also preferred guaranteed work and rewards as a member of a team instead of investing time in an autonomous search of the labour market. Another factor was that *artels* often worked far from home, especially for seasonal work, and it was easier to survive in a commune.

Another feature of this collective spirit was the tradition of gathering in church for service on holidays and sharing the same Christian values. In the 19<sup>th</sup> century, Russian propaganda invented and widely employed the special term *sobornost* (literally, “togetherness”) to emphasise this fundamental characteristic of the Russian people.

None of this means that collective labour was imprinted in Russian DNA. First, the very same *obshchina* was not essentially a collective labour organisation but only a mechanism for redistributing land and tax responsibilities among a farming community. Meanwhile, every household in this community managed its own property (e.g. house and livestock) and was interested in increasing its own welfare. Second, we can identify normal manifestations of individualism across all classes, from landlords to civil servants. Old Russia also had a merchant class that exhibited a form of entrepreneurial and individualistic rational behaviour. Before the 1917 revolution, entrepreneurship was growing actively and was based on healthy individualistic behaviour. Approximately 10% of peasants were independent farmers. The more enterprising and prosperous peasants were termed **kulaks** (literally, “fists”) by their less successful and envious brethren. Therefore, the Russians’ “special collectivist spirit” was in part mythic and a reality.

However, the Bolsheviks did try to eliminate healthy individualism from Soviet society and this had strong negative consequences for the development of a post-Soviet market economy. In the 1920s-1930s, several waves of repression were targeted various forms of “entrepreneurial” behaviour. The state expropriated property from and even executed or exiled those accused of engaging in such “anti-Soviet” behaviour. The Bolsheviks did not trust peasants in general and they especially disliked the more successful and wealthy “kulaks”. The most dramatic repressions occurred during Stalin’s **forced collectivisation** of peasant villages. For peasants, this meant a return to serfdom. Against their will, they were enrolled into collective farms from which they had no right to leave. Economically, they lost all private land and livestock. Everything was expropriated to collective farms. Resistance led to severe repression, which in turn led to the deaths of perhaps ten million people and the deportation of millions more. This had a long-standing negative impact as the more talented and entrepreneurial farmers were exterminated.

During the 1960s-1980s, the Soviet regime enacted policies that had another effect on the collective mind of the Soviet people. A new generation of Russians was taught in schools in a strong collectivistic manner with complete denial of selfish motives and individual wealth. Institutions and policies supported this ideology: industrial and agricultural workers had similar wages, there was no obvious unemployment and there were no “wealthy” people. Many accepted this ideology and became true Soviet citizens, performing their social roles, especially working at their jobs with due diligence. The state guaranteed jobs, salaries, food, shelter, medical care and other material needs. This cradle-to-grave paternalistic welfare also hindered the development of

individualism. Several Soviet generations could not perceive themselves making truly independent decisions concerning jobs, medicine or education or on making a choice in the political market; even if they could imagine this, engaging in such practices was not an automatic reflex. During this time, many Russians developed a hostile attitude to profit-oriented behaviour as opportunistic and dishonest speculation (*spekuliatsiia*). When the Soviet Union and its command economy collapsed and market institutions were introduced, these “Soviets” became passive in finding their way around the new social environment. They were less able to navigate autonomously in the new marketplace, which in turn hindered the development of market practices and a thriving market. State policies did not help, although problematic market development was not a function of state policy alone.

Nevertheless, the effect of official Soviet propaganda should not be overstated. Many people were able to preserve egoistic motives. They believed that official values were false and that no one actually believed in them; others more cynically believed everyone could and should improve their lives by playing or cheating the system by shirking, stealing or taking bribes. In fact, because deficits in the quantity and quality of goods and services were endemic to the planned economy, Soviet institutions could actually create opportunities and incentives to act in an individualist, profit-oriented manner. Some Soviets, when good quality meat food was not readily available in stores, utilised personal connections (*sviazi*) with store employees to obtain these goods by privately arranged and illicit means (*nalevo*). Some employees would steal goods or materials and sell them on grey or black markets. Skilled workers (e.g. plumbers) might not work hard at their formal jobs but would work after hours for secret payment in rubles or in kind. This entire complex, termed the **shadow economy**, operated alongside the formal economy, meaning that individualistic behaviour operated in parallel with formally collective practices. However, this type of individualism was not quite the same as the form of individualism associated with healthy capitalism. “Healthy” individualism is tempered by acceptance of social norms and responsibilities and an understanding that an individual’s well-being is well served by cooperating with others, including the state. However, enforced collectivism and state-driven paternalistic welfare in the Soviet Union tended to breed a more cynical and opportunistic individualism, in which individual well-being is served by opportunism, including breaking the law. This type of individualism hinders the development of social trust, civil society and social capital. In the 1990s, such opportunistic behaviour was on display as wealthy “**New Russians**” and “**oligarchs**” employed legal loopholes, political connections and other more cynical tactics to make quick profits from opportunism rather than from adding value; for example, utilising political networks to obtain privatised enterprises at a cheap price or speculating in currency or commodity markets, while average Russians endeavoured to cope with the shocks and challenges of the new economic environment. This gave the post-Soviet market economy a bad image as an economy of true speculators and thieves, which triggered moral outrage and some support for the state paternalism and collectivism that have been part of Vladimir Putin’s policies and legacy.

In sum, Russian and Soviet collectivism in beliefs and institutions ultimately did not create either a healthy collectivism or healthy individualism. Instead, it encouraged the kind of social distrust and opportunistic behaviour that makes the development of a market economy more difficult. However, having seen the excesses of both opportunistic individualism (i.e. 1990s) and authoritarian state collectivism and paternalism (i.e. Soviet era and 2000s), it seems that many Russians are slowly developing a more moderate individualism with due care concerning social trust and civic responsibilities. However, it will take time for this mindset to spread to a

significant part of the population and it will take effort and patience on the part of civic organisations and reform-minded politicians to institutionalise these norms into law and everyday practices of the civil service.

### 1.7 Formal Laws vs. Informal Rules

Another constant of Russian society is the operation of the law. Over a long period, Russian leaders introduced thousands of laws and performed several legal reforms. Almost always, Russian legislators borrowed their legal ideas and reforms from the West, although one Russian legal tradition continued throughout this time: the special role of formal law.

First, there was never true supremacy of law; that is, formal law was never placed above the ruling authority as, supposedly, should be the case in any modern political system. If necessary, Russian political leaders can always sidestep any law to introduce a new one. Usually, the law is not overtly violated, but rather applied in a manipulative way to achieve a desired outcome. The traditional Russian saying for this is: “Law is like a horse, it can be driven in any direction.” Certainly, the tsar or president cannot flagrantly violate the law, as hiding or justifying this would be difficult in public view. However, there are two methods to manipulate the law: alternative interpretations of legal statements or selectively applying one of several contradictory laws or legal norms.

Second, the Russian legal system has always had a special enforcement mechanism. Legal requirements are often so severe that complying with them is unfeasible or even impossible. Correspondingly, the majority of people and organisations comply with laws incompletely or only formally and this with the tacit consent of authorities. This creates *kompromat*, potentially legally incriminating evidence that the state can use at any time. Thus, to manipulate people or organizations, the authorities can simply hint about employing *kompromat* for a prosecution, which usually brings such individuals or organizations into line. According to one Russian saying, “the harshness of Russian laws is compensated by discretionary compliance.”

Third, there are always **informal rules** that are more important than formal laws and that actually govern behaviour in particular areas. For example, there is an informal rule in modern Russia that all oil and gas resources are distributed and managed according to the will of the Kremlin, even though this not required under formal law. Therefore, if any independent company decides to enter the oil and gas market without informally consulting the Kremlin, it risks legal and administrative pressure, including the use of *kompromat*. This tradition of a parallel set of rules, “non-real” formal and “real” informal ones, was established in the Soviet Union. Stalin’s Constitution of 1937 was known as the most democratic legislation in the entire world; however, very few of the rights it contained were actually respected in Soviet society. While this constitution was formally democratic, in practice only one party could stand for election. Freedoms of conscience and speech were formally protected but not honoured. Under Putin, formally democratic elections have been manipulated to produce the Kremlin’s desired results, giving a façade of democracy to authoritarian rule.

## 1.8 Russian Orthodox Church

Today, approximately 70% of Russians consider themselves Orthodox Christians and, although only a small proportion of these people attend church regularly, many of them consider the Church a central element of Russian culture. Indeed, it became a symbol of the country, although its past and present roles are somewhat contradictory.

The adoption of Christianity was not voluntary. In 988, Prince Vladimir I of Kiev decided to introduce Christianity as a uniform religion for all tribes and he organised mass baptism of the population, which was mostly pagan at this time. It seems that Christianity was a **political choice**. Vladimir needed a monotheistic religion to help him impose uniform rule over his lands and he had also entered an important political alliance with Constantinople. Adopting Christianity from the Byzantine Empire served to enhance this alliance.

Orthodox Christianity came to play an important role in the progress of Russian culture and came to resonate with Russian culture and everyday life. Ideas of tolerance and mutual love were eventually warmly supported by Russians and this religion provided some solace for the usual difficult life faced by Russians. Moreover, the Church played a motivational role in crucial periods of Russian history. For example, it is believed that during the Mongol invasions, the Church persuaded powerful Russian princes several times to cease their internal conflicts and obey the Great Prince of Moscow.

However, some features of the Russian Orthodox Church might have been less beneficial for social development. First, the Orthodox faith relied more on mysticism (i.e. sacred rites providing the believer with salvation regardless of his/her behaviour in this life) than on asceticism (i.e. seeking salvation through controlled personal behaviour). The latter was widely practiced in Russian monasteries, but the general Russian population was under the influence of the former. Among other things, Orthodox mysticism did not aid the development of effective business ethics. While Christianity offered positive fundamental values of honesty, forgiving and help to, for example, neighbours, mysticism did not develop this discipline of everyday behaviour. Another factor instilling mysticism in the minds of Russians was dominance of the agricultural population coupled with unstable weather conditions that created feelings of an irrational uncontrollable environment and total dependence on some "higher power". This had several important consequences. First, mysticism meant passive contemplation and quiet repose in God, which led to a fatalistic indifference towards the world and a humble acceptance of the given social order. Russian Orthodox people usually quietly accepted political change and reforms, with only extreme material deprivation and/or injustices leading to mass uprisings. Second, mysticism was responsible for relatively weak personal integrity in ordinary business life; personal sins only being removed by liturgical rites and there being no unforgivable misbehaviour. The poorly developed method of confession frequently took the form of collective admission of guilt, with no real influence on an individual's conduct. The influence of the clergy, who did not follow ascetic practices (e.g. no celibacy), was relatively weak and also could not serve as moral authority. In every peasant house, icons were placed in the eastern corner of the living room and many people covered their icons with a piece of cloth while doing something not approved by the saints depicted by these icons. This act was aimed at concealing misbehaviour, thus weakening the disciplining power of the religious moral code. Third, another side of mysticism was rejecting the importance of success-oriented ethics because sacred rituals will correct all personal errors and inefficiencies in this life.

Politically, the Russian Orthodox Church was subordinate to the political and economic interests of the ruling class. The Church's strategy was to build an alliance with state authority. As discussed later, the most effective way to start a business in Russia at this time, and often thereafter, was to cooperate with the state; for example, to obtain a trading monopoly. However, this alliance demanded compromises from the Church. At first, this contract worked well and both parties acted on the basis of mutual benefit. For example, when Constantinople, the centre of Eastern Christianity, was captured by the Ottoman Empire in 1453, the Russian Orthodox Church proclaimed Muscovy as the Third Rome, the legitimate successor to Constantinople and a very convenient idea for promoting the Russian tsar as a divine ruler with a holy mission. Nevertheless, the state began to expropriate the Church's rights and freedoms. Eventually, Peter the Great broke the contract and made the Church a department of the government run by civil servants. The Church, including church lands and peasants, was nationalised and even the clergy's salaries were paid by the state. At the beginning of the 20<sup>th</sup> century, the Russian Orthodox Church had a chance to win back its autonomy but, in 1917, the Bolsheviks, who were extremely hostile to any religion, proclaimed the complete separation of Church and state, expropriated almost all Church property and imprisoned or executed many clergy. This repression grew to an enormous scale in the 1930s under Stalin. However, in World War II, Stalin partly revitalised the Orthodox Church, which he needed as an instrument for enhancing popular patriotism. After the war ended, Soviet leaders continued their oppression of the Church and deprived it of resources and rights. After the collapse of the USSR, freedom of conscience was supported and the Russian Church began to regain its former social position. Unsurprisingly, Church leaders pursued the time-honoured strategy of developing a new alliance with the state. The Church offered the Kremlin ideological support in return for wide opportunities, for example, to regain property, open new cathedrals and exploit state media for promotion.

### **1.9 A National Character of Russians?**

There is much debate concerning a Russian "national character," although it is difficult to differentiate myth from reality. Theoretically and empirically, the existence and influence of a real "national character" can be a difficult proposition to sustain. We describe some theories for consideration by the reader.

We have described above some historical events that could contribute to the formation of Russian cultural traditions (i.e. fatalism or passivity, tolerance of lack of freedoms, and admiration of state power); for example, the Mongol conquest and its reproduction in Muscovy. There are two geographical factors that might well have contributed to forging Russian character. The first factor is its large territory; Russia occupies one-eighth of the earth's land surface. To rule such a territory, leaders need a strong hand, otherwise even a small degree of discontent might unravel state authority and possibly lead to the fragmentation of state and country. Further, individual or even concerted group action cannot reform this system quickly; many tsarist reforms were undone by successors, for example, after Peter the Great or Alexander II. Thus, patience and submission are rational strategies. This is why political passivity is a rational response even under a disappointing political regime. The second geographical factor is an unfavourable climate. For most of the year, in contrast to the climate of continental Europe, much Russian territory is rather cold. There is also great variation in temperatures during the year. The summer might be hot but short, followed by inter-seasonal rain, causing mud, and then a harsh winter. This led to inefficient allocation of peasant labour; peasants were forced to remain idle for long inter-seasonal and winter

periods and then to work intensively tilling, seeding and harvesting over a short period. There is a hypothesis that this explains several important characteristics of Russian culture. First, such intensive labour contradicted the principle of a rhythmic schedule of work. Second, this explains why Russians could demonstrate short-term intensive bursts of energy. This tradition was enhanced in the Soviet era, when planning targets and propaganda could necessitate last-minute “storming”, or intensive labour to meet a production target. In other words, Russians could be relatively passive for some periods, but then work hard on concentrated efforts, whether meeting a planning target or mobilising heroic production efforts during World War II. Third, some claim that these seasonal patterns explain the Russian inclination for the consumption of alcohol. Put simply, alcohol consumption might be a tactic for coping with enforced inactivity in winter periods. Fourth, such unstable and unpredictable variation in temperature and rain leads to risks of crop failure. This, in turn, contributed to **mysticism** and **fatalism**, which was consistent with Orthodox Christianity.

Caution and conservatism are rational responses to uncertainty, producing more or less guaranteed output and, consequently, rejecting experiments and innovations as risky. This attitude was augmented in the 20<sup>th</sup> century, when Russians had to survive several large scale shocks: revolution, famines, forced collectivisation and industrialisation, a devastating war in the 1940s and then the shock of post-socialism in the 1990s. Perhaps this partly explains why the current Russian population still prefers a stable minimum to potential improvements achieved through possibly profitable but also risky political and economic reforms. Finally, such variation in environment and activity might help explain the supposed Russian preference for extremes: “all or nothing”. Emotional displays can be quite strong. Russian hospitality can be overwhelming, friendship very deep, celebration almost ungovernable and drinking too heavy. However, this might be less a specific Russian trait than normal human behaviour; it might be that the more disciplined “West” has been conditioned differently. This remains a hotly debated topic. Finally, such harsh environmental conditions strengthened a Russian sense of duty to help those on the edge of survival, which can be termed a strong norm “to help the helpless.” Revealing true desperation might change another person’s attitude and position and encourage aid. A corollary to this is that successful business requires establishing **interpersonal relationships** (i.e. some form of friendship) with Russians before conducting serious business transactions, as Russians treat friends and relatives (i.e. “ours”) in a more favourable manner than strangers.

Additionally, limited access to the sea also played an important role before the transport revolution in the 19<sup>th</sup> century. Russia was distant from the main centres of civilisation and progress (i.e. Europe and China), which meant that the country developed in relative isolation from more modern progressive ideas and institutions (e.g. various freedoms or qualities of life). However, there is some dispute concerning the extent of Russia’s isolation.

This overview should be regarded as an idealised picture smoothed and blurred over the last decades, when Russia opened its borders and Western ideas, attitudes, and ways of life more actively entered Russians’ habits. However, it seems that the heritage of the tsarist and Soviet past remains manifest in Russian behaviour.

## 2 NEW RUSSIAN CAPITALISM (1985-2012)

### Maxim Storchevoy and Jeffrey Hass:

In this chapter, we discuss the birth and evolution of the market economy after the collapse of the USSR. We briefly outline the last days of the command economy, Gorbachev's infamous *perestroika*, the painful reforms of Boris Yeltsin and economic growth and contradictory economic change under Vladimir Putin.

### 2.1 Soviet Legacy

Under **Leonid Brezhnev**, the country tried to exploit the advantages of planned development and, at the same time, to copy some trends from capitalist economies. For example, Soviet leaders and planners tried to consolidate enterprises into industrial giants (*kombinaty*) and industrial groups (*obedineniia*) to capture economies of scale. However, this led only to extensive development rather than technological innovation and had little effect on productivity, solving economic problems or altering managerial behaviour. Suggestions by managerial experts were worthless without institutional changes; managers who tried to change behaviour were still operating in a broader context that rewarded risk adversity and one-man management. Also, managers themselves, who generally had worked their way up the factory hierarchy and had internalised particular practices and models of strategies and action, approached new models for running their factories with scepticism or even distrust or hostility.

Such was the formal command economy. However, beneath formal routines and structures, a **shadow economy** of quasi-legal or illegal exchange living parasitically off the formal economy was burgeoning. Ironically, the command economy itself created this parallel shadow economy. First, the command economy created deficits of consumer goods and services. Rather than independent owners and entrepreneurs seeking profit by fulfilling consumer demand, production and sales were guided by plans set by bureaucrats with little incentive to determine consumers' real desires. To meet demand for deficit goods and services, Soviets turned to semi-legal and illegal activities. These might involve stealing materials from enterprises for use or sale on the black market. Soviet managers would negotiate for an informal supply of inputs because the state could not always guarantee the timely supply of quality inputs. Soviets learned the art of utilising networks or **blat** (i.e. patronage) to obtain jobs, consumer goods (i.e. food and non-consumables), services and other opportunities. For services, relevant personnel might perform official duties lightly but work more seriously after hours for illicit pay or payment in kind. For example, anecdotal evidence suggests that plumbers and the like did not take formal requests for repairs very seriously; however, they were more willing to visit apartments after hours and repair leaky pipes for vodka or extra rubles. The extent of shadow activity is difficult to ascertain, although the emergence of small private firms and trades people in the Gorbachev era suggests that there was a narrow but ready entrepreneurial class.

Activity in the shadow economy had several important consequences for Russian "business" during and after the Soviet era. First, shadow activity contributed to economic inefficiencies: theft of materials was informally rewarded, leaving enterprises and consumers without needed goods or services or with low-quality goods and services. Apartments and other buildings were not well constructed because bricks and materials for cement might be stolen so that managers or workers could construct their

own dachas or sell the materials on the shadow market to those wanting to build their own dachas. Second, activity in the shadow economy, coupled with the deficit nature of the formal command economy, reversed the usual market relations of power; instead of sellers being accountable to consumers (i.e. market capitalism), consumers were answerable to suppliers. The incentives were not for fulfilling consumer demand; consumers had to fulfil suppliers' demands. This added to the inability of enterprises, and the "system" generally, to adapt quickly to post-1985 reforms; managers, nascent entrepreneurs and general organisational routines were oriented to placating suppliers and ministries. Third, the shadow economy did not reward value-adding activity, it rewarded speculation. Nascent Soviet entrepreneurs in the shadow economy flourished to the extent they could utilise networks to gain deficit goods and resell them for illicit monetary profit or payment in kind. Finally, this shadow economy hurt not only the legitimacy of the Soviet planned economy but also the normality of the rule of law. Formal rules and laws existed not to defend production or rights but rather as an arm of the overpowering state and Communist Party. In the shadow economy, practices involved not obeying or implementing rules and laws but, rather, their avoidance. Entrepreneurs in the shadow economy, among the early entrepreneurs after 1985, learned how to avoid the law and not to work within it.

## **2.2 Gorbachev and Perestroika**

At the beginning of the 1980s, some party elites understood the necessity for change. The economy was stagnating for a number of reasons: the USSR was subsidising a wide empire in East Europe and beyond, technological innovations were not keeping pace with those in the West, Soviet agriculture was an inefficient black hole for the state budget and Soviet income from petrodollars was evaporating as the price of oil dropped after the Soviet invasion of Afghanistan. Reformist elites felt the economy faced a dead end and sought ways to reform the system. Some historians claim that another reason for change was the realisation by elites that their political power could only bring limited wealth (e.g. the best of not-so-good Soviet cars, apartments or dachas) and they decided to convert political power into material wealth by turning the whole country into a market economy they could manipulate. In 1985, the Communist Party elite chose **Mikhail Gorbachev** to be their General Secretary. His background in law convinced Gorbachev that the rule of law was important in its own right and the example of Khrushchev's reforms Gorbachev witnessed as a youth implanted in him and fellow reformers the need to liberalise and humanise Soviet socialism.

At first, Gorbachev intended only marginal reforms as it was not clear what radical changes were needed. His initial reforms aimed at increasing discipline; for example, cracking down on alcohol consumption and instructing the police to raid cinemas in the afternoons to see who was skipping work. Unsurprisingly, this did little to address economic stagnation and in 1987 Gorbachev moved further towards reshaping the fundamentals of the Soviet economy, especially increasing autonomous private business activity.

## **2.3 Rebirth of Private Business**

Gorbachev's most important reforms for increasing the scope of business were legalising commodities exchanges and cooperatives, a socialist euphemism for private entrepreneurs. The first reform allowed Soviet enterprises and organisations to establish commodity exchanges so that enterprises and smaller cooperatives could

source and negotiate the exchange of goods and services, thus bypassing the state and, hopefully, improving supply as participants had some freedom in setting prices and retaining profits. For the second reform, interested Soviets (i.e. mostly enterprise workers and shop floor bosses, but also outside entrepreneurs) could establish autonomous **cooperatives** in a limited number of areas; cafés were the stereotypical cooperative, although cooperatives also emerged in industrial enterprises whereby workers could engage in additional production or services (e.g. repairs) after formal working hours. Enterprise managers were given some room to transform enterprise structures, including giving individual shop floors some autonomy to set their own prices and wages and to find additional clients outside the enterprise, which was an extension of the logic of cooperative reforms. The reformers' hope was that cooperative and enterprise reform would tap into the shadow economy and encourage such entrepreneurs to engage in value-adding, rather than speculative, activity that would improve overall economic performance and productivity, contribute badly needed innovations and meet consumer needs under-fulfilled by the command economy and becoming a source of possible political friction as Western countries continued to enrich their consumers.

With his reforms, Gorbachev unleashed entrepreneurship, but who were the first entrepreneurs? Not all of it was expected "market" entrepreneurship, characterised by risk-taking, observance of consumer preferences and wants, and innovation in processes and output for servicing that demand. Certainly, such entrepreneurs existed: mathematicians or engineers who wanted to open small garages and expand on their hobbies of working on cars or chemists with ambitions to earn hard currency by serving the needs of foreign tourists. At the same time, new "entrepreneurship" and business could also be activities coming into the open from the shadows. However, the reforms bred unexpected outcomes. Cooperatives emerged ostensibly to service consumer needs (e.g. cafes and restaurants), but public opinion quickly turned against cooperatives as economic parasites or fronts for laundering money stolen in the shadow economy or through organised crime. Reforms also spurred the creation of private financial institutions that lent money siphoned from state banks or the Communist Party. Some enterprise managers utilised cooperatives or financially autonomous shop floors to profit by charging costs to the mother enterprise, then subsidised by the state, while retaining income from sales.

There was also a lack of solidarity between shop floor workers and managers. Ironically, after seventy years, the socialist society ended with corroding social attitudes: paternalism and passivity on the one hand and cynical opportunism on the other. Workers sincerely wanted autonomy to make profit and improve wages, but they often felt managers were exploiting them for corrupt purposes. This contributed to increasing conflict within enterprises, which poisoned working-class attitudes to managers and reforms in general.

The reforms of the 1980s had another bad side effect; they created more opportunities for shadow economy practices, encouraging not only productive business but also fraud, tax evasion and the conversion of political and bureaucratic capital into money. Many profitable businesses were based on appropriating state property or stealing and reselling state enterprises' deficit products.

## 2.4 Yeltsin and the Hard Years of Reform

After the USSR was dissolved in 1991, **Boris Yeltsin** and a team of liberal economists turned Russia to the troubled path of economic reform. They started with rapid liberalisation of exchange and production, privatisation of state property and opening the economy to foreign players. The hope was that such “shock therapy” would lead to a quick recovery after an initial period of painful economic readjustment. Thousands of state enterprises would be privatised by new owners who would quickly adapt to the production of new consumer goods. There was indeed an initial explosion in small entrepreneurial firms; some were new start-ups to address supply of deficit goods and services, while others were legalised shadow activity (e.g. export of timber or oil and petroleum products). However, the market cure became painful and the market transition dragged on for many years.

One reason for this was the relatively passive attitude of employees. Generally, Russian citizens were not yet ready for such radical changes. The majority of employees were accustomed to paternalism and did not have the skills and experience with which to navigate liberalised labour markets. Instead of leaving dying firms and actively seeking new work in growing sectors, these employees could spend years waiting for their enterprises to improve; however, many such firms went bankrupt and workers became unemployed with bitter feelings of injustice.

The second problem was that many large plants and factories were run by **Red Directors**, managers of Soviet-era enterprises, who lobbied for continued subsidies to avoid unemployment and to guard against takeover by foreign investors who, they predicted, would buy and asset strip Russian firms instead of investing in new technology. Red Directors mastered the administrative art of negotiating the politics and networks of bureaucracies, the plan system, and routines of supply and subsidisation. However, the new market required new skills: being able to seek financial support from private investors in return for concrete business plans for addressing market demand and competition. Their learning curves showed much variation. Some Red Directors managed to adapt, while others continued to seek support from the state or turned to complex networks for bartering goods in return for electricity, gas, other supplies and some goods for workers.

The legal aspect of reforms was another uneasy issue. The exact content of legislation was not readily apparent beyond vague and broad guidelines; for example, limits to property ownership, how to defend property rights and setting value for state-owned assets in privatisation. Various judges and officials had insufficient experience with market economies and practices to provide the required support for emerging businesses. Worse, the Soviet system of legal enforcement (i.e. police and courts) was unable to enforce laws in the new business environment with its new risks. This led to the rise of the infamous **mafia**, gangs providing “protection services.” This began in the late 1980s, when strong and aggressive young men in sports suits would approach cooperative managers or new entrepreneurs and demand protection money. Their main weapon was physical violence; if an entrepreneur went to the police, the chances of being protected were much lower than being killed or hurt by racketeers not bound by any law or morality. In the 1990s, this practice became overwhelming; gangsters were organised, armed and often secretly collaborating with the police. Business territories were divided between various gangs and all firms in a particular territory had to pay “protection money”, typically 10-20% of revenue, to the local gang.

**State corruption** began also to increase as official salaries could not keep up with inflation and there were few effective mechanisms for monitoring officials' actions or to protect citizens from a predatory state. Further, officials at various levels utilised access to state property to help business allies; for example, selling state-owned assets at low prices to allies in the private sector. Yeltsin's cabinet was guilty of such practices, especially in the notorious "loans-for-shares" privatisation of the mid-1990s when potentially lucrative enterprises in natural resource extraction, especially oil, were sold cheaply to elite "oligarch" allies such as Boris Berezovskii, Mikhail Khodorkovskii and others.

Ultimately, reforms in the 1990s created a foundation for private business. However, instability, including the shocks of market pricing in 1992 and the government's default in 1998, corruption and a steep learning curve meant that developing a market economy would be a slow process.

## 2.5 Putin and New Russian Capitalism

Yeltsin's reforms gave Russia some political and economic laws that could be a foundation for a free society and efficient market economy. Despite the problems mentioned earlier, market relations, entrepreneurship and foreign and domestic investment did help Russia recover. However, economic success was accompanied by creeping political degradation that led to increased corruption, revival of cold war ideology and failure to conduct further reforms. The crucial role in this process was played by **Vladimir Putin**, who came to power in 1999. Putin generally adhered to developing a market economy and delegated authority over economic policy to liberal and professional specialists, mainly from Yeltsin's team. Being young and decisive, Putin succeeded in returning confidence and respect to the presidency and the state. One of Putin's main political ideas was stability and he managed to create some stability for almost eight years. Putin's luck was that painful reforms had previously been implemented and Russia was profiting from the high price of oil on his watch. However, there were also dangerous and harmful consequences of Putin's rule. He systematically adapted the political systems to his own desires for power and enrichment of his supporters. These factors interfered with economic growth and had bad long-term consequences for Russian business. These factors are described next.

## 2.6 "Rule of law"

Despite occasional reformers' hope or attempts, the rule of law never established deep roots in Russia. Instead, *rule by law* predominated: a situation whereby the political elite manipulate or apply law selectively for its own interests. This was the case in tsarist Russia and the Soviet Union and it again became an important instrument of public administration under Putin. There are three elements that allow the state elite to manipulate the law in Russia. The first is unfeasible technical or economic demands of many laws that cannot be reasonably met by a typical company or individual. The second is the elite's control over the courts, which then selectively punish or ignore companies' or individuals' inevitable violations of complex and contradictory legislation. The third element is adoption of laws that prevent political opponents from posing significant threats to the current authorities.

Some foreign firms have faced continuing problems from the vested interests of the Russian state and its oligarch allies. For example, Russia has employed environmental

audits and regulatory threats several times to restore state dominance over oil and gas supplies. This tactic was employed to gain a controlling stake in the international gas consortium Sakhalin-2. The consortium, as a production sharing agreement, was formed in 1994 by Royal Dutch Shell (55% shareholding), Mitsubishi (20%) and Mitsui (25%). In 2005–2006, the consortium became the object of legal attacks by the main Russian environmental agency, Rosprirodnadzor, with accusations of violating environmental regulations. Under legal and political pressure, the consortium was forced to sell a majority stake to Gazprom and criminal accusations were dropped.

Another example of this tactic involved Kovykta. In 2003, when foreign companies were still welcome in the Russian oil and gas industry, TNK-BP, a joint-venture of British Petroleum and Russian private business consortium AAR, obtained a license to develop the Kovykta gas field in Siberia. However, eventually Gazprom realised that exporting gas to China from this field was strategically important. Once again, pressure was applied over the license agreement. In 2006 TNK-BP was accused of not meeting the terms of its contract to produce nine billion cubic metres per year from the field. However, this production was economically unfeasible because local demand for gas in Irkutsk was several times smaller than necessary. The company had initially planned to ship gas to other regions and abroad. However, Gazprom, which was responsible for building a pipeline and had exclusive rights for the gas trade, broke its promise to build the pipeline with the excuse of concentrating on “more important projects”. The company could extract gas which it would then have to burn immediately on the field. This would make the contractual stipulation absurd in a normal court, but not in Russia. The Kremlin preferred to stick to the letter of the law as this brought dividends. The output clause gave legal grounds to revoke the license. TNK-BP tried to make an offer similar to a recent Sakhalin-2 deal: 51% of shares at market prices to Gazprom. However, this time the deal was different. Sakhalin-2 was a technically sophisticated field that Gazprom could not develop without the help of Shell; thus, Shell was kept in the project to do the dirty work. In contrast, Gazprom did not need help to develop Kovykta. As THK-BP felt that it might lose everything, in 2010 it employed a bankruptcy manoeuvre to sell its Kovykta division to Gazprom at a price covering its investment plus a very small margin (i.e. \$770 million).

## 2.7 Oligarchs lose power

Designated *de facto* as Yeltsin’s heir, Putin owed his new position in part to lobbying by the **oligarchs**, the Yeltsin-era financial and property elite, led by Boris Berezovskii. A former mathematician, Berezovskii was able to make money in the 1990s as a co-founder of LogoVAZ, the largest distributor of the main Soviet car, Lada, and other projects. Later, he increased his wealth through loans-for-shares auctions. In the late 1990s, he was very close to Yeltsin’s circle and had significant impact on his policies. It was Berezovskii who proposed Putin as Yeltsin’s successor. The oligarchs supported this idea, believing Putin would continue Yeltsin’s general policies and leave the economy to the oligarchs. However, Putin soon built his own base of power around the security forces, informally termed *siloviki*, whose main weapons were professional access to *kompromat* (i.e. legally compromising materials) and to manipulate law enforcement to threaten opponents. Putin employed such resources and tactics in the early 2000s to remove Berezovskii and Vladimir Gusinskii. Both owned central TV channels that openly criticised Putin’s mistakes and they were forced to sell these channels at large discounts to Putin’s allies. Later, Putin jailed another wealthy opponent, Mikhail Khodorkovskii (see below). This became a clear signal to all other magnates not to question the Kremlin’s authority and the Kremlin would not question

their business practices. The elite accepted the deal, contributing to general political passivity.

## 2.8 Vertical Authority

One of Putin's political strategies was to create a "power vertical" from the Kremlin down to local and municipal officials, a structure modelled on Belarusian dictator Aleksandr Lukashenko's method for controlling his country. For example, in 2004 Putin eliminated the direct local election of governors and decreed that they would be appointed by the Kremlin; he almost eliminated the election of mayors and appointed Kremlin representatives to the regions to supervise local politics. The formal excuse for this was the Beslan tragedy, a terrorist act at a Beslan school carried out by Chechen militants, and claims that local officials might be manipulated by wealthy or criminal groups. However, this "power vertical" did not work as well as Putin had hoped. The main problem was an informal **social contract** between the Kremlin and appointed regional officials. The Kremlin agreed to leave these officials in place if they agreed to guarantee "good voting" at presidential and Duma elections for Putin's ruling party, United Russia, and to reduce the influence of possible dissent. The Kremlin did not seem to care overly about local corruption; for example, embezzlement of funds from the state budget, bribes or raiding private businesses. Putin made a similar arrangement with average citizens: exchanging political loyalty for freedom to earn and consume. The real influence of the Duma, the lower house of the Russian parliament, was nullified with the help of the mainstream political party, United Russia, which employed administrative power to win elections and to form a majority in the Duma. This enabled Putin to pass any legislation he chose and to craft a new *dirigiste* economy; not as state-owned as during the Soviet era but with a stronger hand than envisioned in the reforms of the 1990s. A similar manipulation was conducted with the court system (i.e. the Constitutional Court and also ordinary courts). Judges never ruled against the Kremlin and, in return judges gained the informal right to hold their positions without limitations.

## 2.9 State crony capitalism

Eventually, Putin created an economy that resembles traditional political economies of developing countries in Latin America and Asia. Putin created a variant of **state capitalism**. He favoured creating large corporations for most major sectors: Gazprom (i.e. gas), Rosneft (i.e. oil), Rostekhnologiiia (i.e. engineering and machinery, automobiles and weapons), the United Aircraft Corporation (i.e. aircraft industry), Rosatom (i.e. nuclear power industry) and others. The general idea was that larger companies were easier to control and only the state was in a position to ensure finance for risky innovation needed to develop a high-tech economy. Putin referred to successful examples of Chinese state conglomerates and South Korean chaebols that were able to achieve leading positions in global markets. He could also refer to Russian historical experience, which showed that all significant periods of economic growth and modernisation were fuelled by the state and not by private business; for example, Peter the Great or Stalin. However, these exceptional leaders were ascetic idealists focused on effectiveness and intolerant of self-interested managers. Putin is a different leader who might keep inefficient officials in place because he believes "stability is more important than efficiency" and "any successor will be more or less the same". This is why many experts have doubts that these state conglomerates are close to efficient. Further, there were politics in the shadows that might explain this renationalisation of large

enterprises. In particular, the Russian elite understood that it was not necessary to own a company to manipulate its resources. Elites could own such firms' shares that, if state renationalisation meant increased capitalisation, could later be sold at a higher value. Further, to serve their interests, private elites could negotiate with allies in the Kremlin to divert company resources into public projects that could not be obtained with direct funding from the state budget. This is how many important public projects in Russia, such as projects relating to the 2014 Winter Olympics, have been financed not from the state budget but by "voluntary" contributions from Gazprom, Sberbank and other large companies.

At the same time, Putin explicitly and implicitly favoured a model of crony capitalism. Certainly, nepotism was not new but, in Putin's era, this approach was expanded. Putin actively appointed allies from past years in the KGB to key positions (e.g. CEO)<sup>7</sup> in the state and large companies. These allies supported Putin by financing his political and ideological projects. For example, large companies bought all major TV channels or major newspapers to shape public opinion. Several people were astonishingly successful in business, beginning as unknown entrepreneurs or managers and becoming Forbes billionaires in a few years because they had informal relationships with Putin and his elite<sup>8</sup>. This model of crony state-business relationships was not exclusive to the Kremlin, regional state officials also favoured their relatives and friends in business developments. It was not rare to discover that the most successful entrepreneur in some territory was the son or wife of the local major or governor<sup>9</sup>.

Russia has lacked legal lobbyism since the beginning of its market development. Although the necessity for legal regulation of lobbying has been much discussed since 1993, significant legislation has never been adopted, mainly due to the unwillingness of the Russian authorities that explain this as the "political immaturity of Russian members of parliament". However, the absence of such a law does not mean the absence of the phenomenon. Quite the opposite, the practice of influencing Russian authorities was always widespread but informal. An RSP survey reported that, in 2012, the overwhelming majority (80%) of top managers believed that the most effective instrument of lobbyism was personal connections; only 20-30% agreed that formal channels of communication with the state (e.g. conferences, round tables and working groups) would be useful. To obtain political and legal support, business people keep top state officials on their payrolls or make them confidential beneficiaries of their businesses.

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<sup>7</sup> Examples include Alexei Miller (CEO of Gazprom) and German Gref (ex-Minister of Economy and Chairman of the Board of Sberbank), who were Putin's subordinates during his work in the St. Petersburg city administration. Igor Sechin (Deputy Prime Minister and Executive Chairman of Rosneft), Alexei Kostin (Chairman of the Board of VTB bank) and Andrei Akimov (Chairman of the Board of Gasprombank) were Putin's former colleagues during his KGB service. Yuri Kovalchuk (Chairman of the Board of Rossia Bank), Andrei Fursenko (ex-minister of education), and Vladimir Yakunin (head of Russian Railways) worked with Putin in Ozero, a dacha cooperative society in the 1990s.

<sup>8</sup> The most striking example is Gennady Timchenko, founder and manager of the Gunvor oil trading firm (registered in the Netherlands), which grew from a small business to the world's most powerful independent trader of Russian oil (40% of all exports) after Putin came to power. Timchenko was Putin's business partner during the latter's days in the St. Petersburg administration, although both denied any friendship.

<sup>9</sup> The best example of this model is Elena Baturina, the most successful female entrepreneur in Russia, a Forbes billionaire who is also the wife of Yury Luzhkov, Mayor of Moscow from 1992 to 2010. Other good examples are Sergey Matvienko, a billionaire and owner of several large developmental companies, and a son of former St. Petersburg governor, Valentia Matvienko.

Crony capitalism has its pitfalls. State connections are a quick way to wealth; however, what the state gives, it can take away<sup>10</sup>. This is why even the most successful business people and oligarchs always seek ways to leave the country with as much wealth as possible. Many have spirited families and wealth to Europe, especially London, and the United States. Another consequence is that large businesses regard the Russian legal system with scepticism and, thus, register or re-register their companies in **offshore** jurisdictions. Experts say that approximately 80% of all transactions with Russian assets are conducted outside the Russian legal system. The most popular jurisdictions are, for example, Cyprus, the Bahamas, the Maldives and Switzerland. The largest Russian companies owned by the richest Russian oligarchs are registered offshore: the largest steel company NLMK is registered in Cyprus and the largest aluminium producer, RUSAL, is registered on the island of Jersey. Tax minimisation is another reason of utilising offshore jurisdictions<sup>11</sup>.

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<sup>10</sup> A good example is the rapid retreat of Elena Baturina from Russian business after her husband Yury Luzhkov lost favour with the Kremlin and was evicted from his position as mayor of Moscow.

<sup>11</sup> The basic tax rate for profit in Russia is 20%, but is only 10% in Cyprus. The tax on dividends is 9% in Russia, while it is half this or zero in many offshore jurisdictions.

### 3 BUSINESS LAW AND REGULATIONS

**Maxim Storchevoy and Jeffrey Hass:**

#### 3.1 The legal system

The Russian legal system and business law are complicated despite reforms since 2000 and whether the “rule of law” is truly operative remains debatable. In part, this is due to the rapid and radical transformation of the economy from socialism to market capitalism. Devising the necessary legislation faced hurdles from conservative or corrupt politicians, managers and state officials, and even the best intentions sometimes went astray simply because politicians, bureaucrats, managers and entrepreneurs had no firsthand experience with how market capitalism works in practice. Further, different groups pursued their interests outside the bounds of law (e.g. the infamous *mafia*) or by employing law for their own needs (e.g. *siloviki*, security services at the highest levels of government). While laws and the courts are important for governing business, one must be aware of their shortcomings and also rights to prosper within the Russian system.

The fundamental law of the land is the **Constitution** of the Russian Federation, which sets basic civil rights and the rules of the political system. The current Constitution was proposed by Boris Yeltsin and approved by popular referendum on 12 December, 1993. Yeltsin’s goal was to increase the power of the executive branch, vis-à-vis other branches of government, as a response to two years of gridlock and confrontation with the previous legislature, the Supreme Soviet. Vladimir Putin introduced additional changes that expanded presidential powers. For example, after legal changes introduced by Putin in 2004, regional governors are now appointed by the president rather than elected locally, which was the previous procedure. Also, Article 31 states that “Citizens of the Russian Federation shall have the right to assemble peacefully, without weapons, hold rallies, meetings and demonstrations, marches, and pickets.” However, legal changes under Putin require that public meetings be approved by local authorities, which local elites utilise to prohibit unwanted street action by opposition forces<sup>12</sup>. Similarly, many important constitutional norms are not followed by the government without the help of additional acts or laws, or they are followed literally but broken in practice. For example, Article 29 provides for freedom of speech and prohibits censorship; however, all major television channels, the main form of mass media for shaping public opinion, are controlled by the Kremlin, which forbids or circumscribes discussion on particular topics or individuals that the Kremlin elite consider threatening to their interests.

The **Civil Code**, adopted in 1994 plus amendments added from 1996 to 2003, is the fundamental set of business norms and laws of the Russian Federation. This code introduces legal actors into the economy and issues of civil rights (section I), property rights (section II) and contracts (sections III and IV). The Civil Code was supplemented with Part Four in 2010, which defines intellectual property rights (i.e. copyrights). While basic norms in this domain are defined by the code, many subsections are

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<sup>12</sup> Since 2009, a group of civil rights activists has taken to the streets of the 31<sup>st</sup> day of each month that has 31 days to claim their right to assemble peacefully. Each time, members of such marches have been arrested by police so that the Russian government can demonstrate who holds real power in the country. In sum, a constitutional norm has been overridden by “regulations” of lesser standing, revealing the true nature of the “rule of law” under Putin and his coterie.

regulated by additional laws. For example, while the notion and basic norms of the joint stock company are defined in the Civil Code, the full set of norms on the establishment and operation of this business entity is laid down in the Law on Joint Stock Companies, adopted in 1995.

Several other areas of economic activity are supported by corresponding codes. The relationship between employers and employees is governed by the new **Labour Code** of the Russian Federation, adopted in 2010. Allocation and appropriation of land is governed by the **Land Code** of the Russian Federation, adopted in 2001. Export and import operations are governed by the **Customs Code** of the Russian Federation, adopted in 2005. Tax responsibilities for natural and legal persons are governed by the **Tax Code** of the Russian Federation, adopted in 1998. All codes are supplemented by countless acts and by the government or ministries responsible for these areas. As a result, proper business behaviour in all areas, especially concerning taxes, requires constant monitoring of a wide variety of sometimes confusing or contradictory legislation. An industry of consultants has emerged to satisfy business demands for knowledge on modifications and appropriate strategies for coping with potential problems.

Below, we briefly discuss laws and legal norms for core areas of business. Note that we primarily address formal laws. Actual state behaviour does not always conform to the spirit of the laws, as our discussion on the political economy of Russian business reveals.

### 3.2 Legal forms of business

The range of Russian legal forms of business resembles that in some continental European countries, which were employed as models by the authors of Russian legislation. The process of registering all legal forms of business is founded on the special federal law *On the Registration of Legal Persons and Individual Entrepreneurs*, adopted in 2001.

The simplest legal form of business is the **individual entrepreneur**. This business form was once termed, for example, “individual private entrepreneur” or “individual private entrepreneur without legal individual form”. In the Western legal tradition, this is a *sole proprietorship*. Any person can register himself or herself as an individual entrepreneur. No additional legal entity is created in this instance. This legal form is usually utilised by very small businesses in trade, transport or services. The formal business name usually contains the abbreviation “ЧП” (i.e. “ChP”, or Private Individual) and usually looks like “ЧП Смирнов А. А.” (i.e. “Private Individual Smirnov A. A.”). An individual entrepreneur can enter into contractual relations and borrow money, although some types of economic activity, such as trade in alcoholic beverages, or some licenses are not available to them. The individual entrepreneur has *unlimited liability* for all debts incurred and some large companies or banks might avoid dealing with them. The individual entrepreneur has some tax advantages; for example, they do not pay property taxes on assets employed in their business activity and they do not pay taxes twice from their distributed income, they only pay a profit tax and no income tax. However, they must contribute a fixed tax to social funds that grows slightly every year; this was approximately 7,000 rubles in 2009 and 16,000 rubles in 2011.

As in many countries, a legal form of **partnership** exists, although it is not common and is usually utilised for professional services such as consulting or accountancy. The

most popular legal form for small and medium business is the **limited liability society** (OOO, *obshchestvo s ogranichenoi otvetstvennostiu*). As an example, the hypothetical OOO “Tea and Coffee” might have several founders and owners and, correspondingly, the charter capital of OOO is divided up into “*doli*”, or percentages of owners’ contributions. Approximately 180,000 firms have OOO status in St. Petersburg. As no minimum level of economic activity is required to keep this form of business is formally valid from year to year, it is often employed not for the production of real goods and services but only for holding assets (e.g. intellectual property) or for the transfer of funds, often in grey or black markets<sup>13</sup>. Many “empty” OOO firms are registered for “tax optimisation” schemes or illegal monetisation of money in bank accounts. The membership of owners can change according to the Civil Code or special procedures written into the charter. In the 1990s and 2000s, it was fairly easy to register an OOO because requirements for minimum capital were comparatively low, 10,000 rubles (approximately €250), and founders could utilise assets such as computers, cars and furniture to contribute to charter capital. However, the government is developing a new law to increase the required amount of charter capital for an OOO to a million rubles (approximately €25,000). This is a significant concern for many owners of OOOs (e.g. cafés and small retail firms) whose amount of charter capital is low.

For larger businesses, the OOO form is inconvenient because it is harder to divide and operate ownership rights when a larger number of owners are involved. To attract ten or more owners or investors or to introduce profit sharing schemes for top managers (e.g. giving them small shares of capital), it is more convenient to utilise the **joint stock company** form, of which there are two forms in Russian law. The first, similar to the OOO, is the private joint stock company (*zakrytoe aktsionernoe obshchestvo*, or ZAO). The main difference between the ZAO and the OOO is that charter capital is divided into shares (*aktsii*) that can be distributed or moved between shareholders. The registration of a ZAO is similar to that for an OOO, with minor differences: if capital contribution is made in kind, the sum must be estimated by independent appraisers. However, the minimum size of charter capital is 100,000 rubles. The second type of joint stock company, the **public joint stock company** (*otkrytoe aktsionernoe obshchestvo*, or OAO), is employed for large companies that attract significant equity or debt finance. Registration of an OAO requires significant initial charter capital, a million rubles, and also a good deal of bureaucratic paperwork. As an open company, the OAO must regularly disclose its financial statements to the public. An OAO is subject to regulation by the Federal Securities Commission. When company size is not too large, choosing between the ZAO and OAO is not straightforward, especially if there are fewer than 50 shareholders. However, the OAO form is required if one founder is Russian citizen or an organ of the Russian government.

Many law firms offer services to aid legal registration of firms. Registration for an individual entrepreneur might cost approximately 5,000 rubles; registration of an OOO might cost 10,000 rubles; and registration of an OOO with a foreign co-founder could cost 15,000 rubles.

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<sup>13</sup> For example, in 2004, when Mikhail Khodorkovskii was arrested and his company Yukos was put under the compulsory bankruptcy process, the assets of the latter were to be sold at auction. Rosneft Oil intended to buy the core production subsidiary of Yukos, Yuganskneftegaz, but it was afraid to participate directly in the auction for legal and publicity reasons. Instead, they utilised an OOO registered two weeks before the auction with minimum charter capital (€250). At the auction this OOO (i.e. Baikalfinansgrup) paid 261 billion rubles (\$9.3 billion) for Yuganskneftegazm, which it then sold to the “bona fide” buyer, Rosneft Oil.

### 3.3 Taxes and accounting

During the 1990s, the Russian tax system underwent various reforms reflecting continuous attempts to maximise tax revenues. One of the hardest tasks was to stop Russian entrepreneurs from avoiding paying their taxes. In the 1990s, even though the economy was depressed, tax rates were quite high and a small business might pay 100% or more of its profit in taxes. Enterprises devised numerous ways to avoid taxes. Wages and salaries were paid informally, in envelopes, to reduce the formal size of the wage fund and to decrease the united social tax (26%), a real burden for businesses. Formally declared profit was often less than real profit to reduce the profit tax. Real profits were hidden under the cover of various “expenses” that were wired to special “monetising” or “cashing” firms and then returned to the company’s owner in cash with a small (e.g. 1-3%) deduction for the service. Other companies employed so-called “insurance schemes”, whereby a significant part of salaries were transferred to employees as part of their insurance packages.

In 2011, the main taxes imposed on Russian businesses were:

**Value added tax (VAT):** calculated on the sales value of goods, services and work at a general rate of 20%, with certain exceptions. Imported goods are also subject to VAT.

**Insurance payments:** since 2011, this replacement for the united social tax (26%) was levied on salaries and paid to three funds: the Pension Fund (20%), the Health Insurance Fund (FOMS, 3.1%), and the Social Security Fund (2.9%).

**Personal income tax:** calculated as a flat rate of 13%. However, non-residents pay 30% income tax on their incomes.

**Profit tax:** levied on a firm’s gross profit. The general tax rate is 24% of gross profit, with some exceptions. Distributed dividends are taxed at a rate of 9% for residents and 15%, deducted at source, for non-residents.

**Excise tax:** levied on the sale or import of particular goods (e.g. alcohol, tobacco, jewellery, cars, oil and gas). The tax rate varies for each product.

**Sales tax:** levied by local authorities at a maximum rate of 5% on the value of goods and services sold in wholesale and retail stores. Particular types of good and service are tax-exempt.

**Land and property taxes:** levied by local authorities at a rate depending on the location of the property.

To avoid higher tax rates for non-residents, a foreign entrepreneur can be formally considered a Russian resident if he/she resides in Russia for at least 183 days in each calendar year. Cash can be repatriated from a Russian branch of a foreign company without restrictions after profit tax has been paid by the branch. However, repatriation of profits by a subsidiary requires payment less Russian tax (e.g. 15% on dividends and 20% on interest) unless there is a double tax treaty between Russia and the foreign company’s home country.

Individual entrepreneurs or small companies can employ a *simplified tax regime* and pay 6% of gross revenue or 15% on revenue less all expenditures, and then not pay any other taxes (e.g. value added tax, profit tax, social tax)

The fiscal year in Russia ends on 31 December. Every company is obliged to make VAT payments, united social tax payments and advance payments on the profit tax on a monthly basis. After the end of the fiscal year, the company has three months to fully account for the previous year and to submit final annual financial statements by 30 March, with corresponding adjustments in taxes paid.

### 3.4 Customs

Customs regulation in Russia is a considerable hazard and problematic for foreign and domestic firms who move goods across borders. It is highly bureaucratised, cost-inefficient and full of hidden traps that might be utilised by fraudulent custom officers to extort bribes for facilitating customs procedures. The basic regulations of customs procedures are described in **The Customs Code of Russian Federation**<sup>14</sup>; however, there were thousands of various amendments and instructions subsequently adopted that specify and modify the code.

Russia employs the international system of **product names** for classifying traded products, known as the *Harmonised Commodity Description and Coding System*. The **value** of a product is estimated in line with the DAF (i.e. Delivered at Frontier) principle.

The size of import and export duties reflects the economic policy of the Russian federation to find a balance between three factors: economic growth, protectionism and maximisation of tax revenues.

A company importing a product to Russia faces four types of payments. First, it has to pay **import duties** that are applicable to almost all products, except for some goods considered strategic for economic development; for example, equipment and machinery. In most cases, duty rates are calculated *ad valorem* and fall between 5% and 20% of the goods' value. The final rate depends on the country of origin. There is a list of the *most favoured nations* that pay 70% of the tariff rates, all other countries (e.g. Sweden or Finland) have to pay double rates. The rates of custom duties were defined in *The Customs Tariff of Russia*<sup>15</sup> until the end of 2009, when Russia, Belarus and Kazakhstan formed a Customs Union and introduced a *Common Customs Tariff*<sup>16</sup> for all union members. Second, a company might have to pay **import excise tax** for some goods such as alcohol or tobacco. Third, it will have to pay **import VAT** of 10% for several groups of goods (i.e. food, printed products, drugs and children's goods) and 18% for all other goods. VAT is calculated on the basis of the sum of the customs valuation of the goods, import duties and import excises for these goods. VAT is not paid for some types of equipment. Fourth, the importing company will have to pay a **customs processing fee** that varies from approximately 600 to 120,000 roubles per customs declaration, depending on the customs valuation of imported goods.

<sup>14</sup> Full text in English: [http://customs.ru/special/tk\\_en/](http://customs.ru/special/tk_en/)

<sup>15</sup> The English text can be found at <http://www.russian-customs-tariff.com>

<sup>16</sup> The Russian text of the Common Customs Tariff can be found at the website of intergovernmental commission responsible for adopting the tariff: <http://www.tsouz.ru>

However, there is some relief for specific categories of imports. Goods can be imported under a **temporary import customs regime** if they are intended to be re-exported. This regime is granted by custom authorities for a period of up to two years and requires payment of 3% per month of the total customs payments due had the goods been imported for free circulation in Russia. There is full exemption from custom duties and VAT in the case of **tolling**, if the goods are to be processed on Russian territory and then moved out of Russia within a specified deadline. No custom duties are paid on goods imported by a foreign investor as a **charter capital contribution**. There are **several special economic zones** in Russia with a free customs regime<sup>17</sup>. Any foreign goods can be imported to special economic zones without custom duties or import VAT; however, if they are subsequently moved to other parts of Russia for free circulation, they are taxable by usual custom duties and VAT.

The process of custom clearance is quite complicated and should be delegated to a customs broker. The cost of customs clearance for many goods with one customs import declaration transported in one vehicle is approximately 30,000 to 50,000 roubles. However, the cost per declaration can be significantly lower if a company sends many vehicles per month.

### 3.5 Opening a Business: Licenses and Permits

To establish a business in Russia, a large number of bureaucratic issues must be solved in addition to registering the legal entity. The majority of these issues relate to obtaining various **licenses** and **permits** from authorities of different types and ranks.

Although **land** can be private property in Russia, most Russian territory is not privately owned but belongs to the state and is administered by various federal, regional or local authorities. All land issues are governed by the *Land Code of the Russian Federation*, adopted in 2003 and subject to frequent amendments. When deciding to build facilities, one might buy the land; however, the majority of companies prefer to rent the land from the authorities. All information on land plots is accessible from the respective regional department of *Rosreestr* or *Federal Service for State Registration, Cadastral Records and Cartography*, which is responsible for land surveying, appraisal and registration of all changes of property rights to land and immovable property<sup>18</sup>. There is no discrimination between Russian or foreign citizens and entities in relation to rent or ownership of land. However, most land outside cities is usually classified as agricultural or “for agricultural purposes”, even if there are no current farming activities, and cannot be bought by foreigners. Employing this land for non-agricultural business is possible after its reclassification under the broad category “for industry, energy, transport, communications, etc.” Further development of such land (e. g. building new facilities) requires compliance with another important piece of legislation, the *Town Planning Code*, adopted in 2004, that regulates all **construction permits** and **permits for commissioning**. This is one of the most costly and time-consuming procedures for opening a new business, although there has been progress in recent years in simplifying this procedure. For example, before 2007, the process of reviewing construction project documentation and issuing construction permits required multiple appraisals by various state services. In 2007, this was replaced with a

<sup>17</sup> There are four technological zones (i.e. St. Petersburg, Zelenograd, Doubna and Tomsk), two industrial zones (i.e. Lipetsk and Elabuga), a special economic zone in Kaliningrad and seven tourist zones.

<sup>18</sup> Much information, including an interactive map of all cadastral land, can be found at the website <http://rosreestr.ru> (only in Russian).

single “state appraisal” procedure. Nevertheless, obtaining a construction permit in Russia remains a longer and more expensive procedure than in most other countries. In 2011, this required 540 days in Russia but only 66 days in Finland or 116 days in Sweden.

Many business activities do not require **licensing** if they do not present any likely harm to people’s health or security. However, there is a long list of business activities that are deemed to require a license from the relevant governmental body responsible for a specific sphere. The most obvious areas include dealing in medicine or weapons, fire fighting or healthcare. Among others, any activity involving personal confidential information requires a license from *FSTEC*<sup>19</sup>, any activity involving cryptography or surveillance requires a license from *FSB*<sup>20</sup>, any production of audio, video or software goods requires a license from *Roscommnadzor*<sup>21</sup>, any production of pyrotechnics, aircraft or game machines requires a license from *Minpromtorg*<sup>22</sup> and all transportation services require a license from *Rostransnadzor*<sup>23</sup>. The full list of activities requiring licenses is defined by the government act “On organisation of licensing of some business activities”, adopted in 2006. However, in recent years, several types of activity were excluded from this list and moved under the governance of self-regulatory organisations. For example, since 2008, auditing services and construction services do not require licenses. However, companies involved in these businesses need to be a members of the relevant self-regulatory organisation.

The operation of any business facility and especially any facility dedicated to working with people (e.g. a store or an educational facility) requires regular approval by two authorities, the ability of which to worry entrepreneurs has become an object of black humour and part of business folklore. These authorities are informally termed *pozharniki* (i.e. “fire-fighters”) and *SES* (i.e. the sanitary and epidemiological service). **Pozharniki**, or State Fire Control Service, is supposed visit any business entity at least once a year to inspect for potential fire hazards. Instructions defining the minimum level of safety are complicated and, thus, can enable an inspector easily to cite violations of fire control rules (e.g. improper type or number of fire extinguishers, improper number, location or size of exits from the premises and improper material utilised in floors or walls). **SES**, or State Sanitary and Epidemiological Service, should visit any business entity no more than once every two years, although there can be “special” inspections if SES has grounds (e.g. customers’ complaints) to suspect violation of sanitation norms. Instructions defining the required level of sanitary conditions (e.g. cleanliness, lighting, air circulation and safety of equipment) are even more complicated than those for fire safety. It is easy to formally accuse a business of violating sanitation norms and to require costly remedial measures or even discontinuation of operations. The dark side of this regulation is that, in many cases, the demands of these two controlling authorities are eliminated by bribes, which is often the real purpose for such painstaking “control”.

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<sup>19</sup> Federal Service for Technical and Export Control, <http://www.fstec.ru> (no English version).

<sup>20</sup> Federal Security Service (former KGB), <http://www.fsb.ru/> (no English version).

<sup>21</sup> Federal Service for Supervision in the Sphere of Telecom, Information Technologies and Mass Communications, <http://www.rsoc.ru/> (one-page English version).

<sup>22</sup> The Ministry of Industry and Trade, <http://minprom.gov.ru> (one-page English version).

<sup>23</sup> Federal Service for Transport Control, <http://www.rostransnadzor.ru> (no English version).

### 3.6 Dispute resolution

It is wise to avoid commercial disputes in Russia for two reasons. First, Russia's legal system is quite formalistic and often the letter of a law supersedes the spirit of a contract or the law. A judge often relies on the literal meaning of contracts. The legal system has a poor tradition of extrapolating incomplete contracts and laws on the basis of universal principles of justice and efficiency that is common in the Anglo-Saxon legal system. Second, in Russia, the court can be manipulated by the state, which is especially dangerous when one's legal opponent is the state, or by a private party through informal connections or bribes. Therefore, there is no guarantee that one can find protection from Russian courts, which is why Russians employ informal methods to resolve conflicts. This can be manifest in developing personal relationships with contract partners beyond that which is normal for Western business "neutral" relations.

However, if a conflict arises, parties can try to defend their interests in the **Commercial Court** (i.e. in Russian, *arbitrazhny sud* or "arbitration court"), a special court established to rule on contractual and property disputes between businesses. If one party to a contract feels that the second party broke an agreement and did not provide credible and reasonable promises to fix the problem, it can file a claim with a regional branch of the Commercial Court. The litigation procedure is governed by the **Commercial Procedure Code of the Russian Federation**<sup>24</sup>. Proceedings in commercial courts are conducted in Russian. However, for persons participating in the case and not having command of the Russian language, the commercial court grants the right to access case materials, to participate in judicial actions and to speak in court in their native language, employing the services of an interpreter. Judicial decisions of commercial courts are binding on all parties to a case and public authorities in the whole territory of the Russian Federation. Usually, a full cycle of litigation can take six to 12 months. Proceedings in commercial courts are open and all decisions of the commercial courts are collected in a data base available at the appropriate web site ([www.arbitr.ru](http://www.arbitr.ru)). Currently, the data base of decisions contains over 13.6 million judicial decisions and has a free retrieval system with the facility to search by various categories; for example, names of the parties in the case, dispute category or wording of the judicial decision. The types of case in the Commercial Court can be categorised as approximately 45% contract and property disputes, 45% disputes with the state (i.e. administrative cases) and 10% insolvency and other disputes.

Another option is an **Arbitration court** (i.e. in Russian, *treteysky sud* or "third-party court"), a less formal dispute resolution mechanism through which two parties voluntarily decide to entrust their dispute to a third party and agree to be bound by its decision. Arbitration courts have closed (i.e. private) proceedings and might be preferred by a business that either does not want the dispute to become public knowledge or needs a faster or more sophisticated solution. However, if a dispute is not resolved in the arbitration court, the case will be moved to a regional branch of Commercial Court with its standard legal proceedings. The **Law on Arbitration Courts** regulates the process of establishing and operating these legal structures. According to this law, an arbitration court can be established by any legal entity; however, it must be registered through submission of a few documents to a regional branch of the Commercial Court. There are approximately 400-500 Arbitration Courts in Russia, established mainly by, for example, various regional trade and industrial

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<sup>24</sup> An English translation of the code can be found at the web-site of the Commercial Court (<http://www.arbitr.ru>).

associations, chambers of commerce and legal firms. Arbitration courts operate faster than commercial courts; in the former, it can take 30-50 days from submitting a case to obtaining a decision, compared to 180-360 days in the latter. Nevertheless, an arbitration court's decision has the same legal force as decisions of a commercial court and, if necessary, will be enforced by the latter. Paradoxically, the execution of an arbitration court's decision in the territory of another country can be easier than is the case with commercial courts' decisions. This is because Russia has ratified the international convention concerning acknowledgement of arbitration decisions; however, there is no such universal convention for commercial courts, for which countries need bilateral agreements. As such, wise parties to a contract normally include a special "arbitration clause" in the contract stating the types of contractual dispute, if they arise, that should be taken to a particular arbitration court.

## 4 CONCLUDING REMARKS (PT. 2)

For Finnish entrepreneurs who are going to do business in Russia it is important to understand historical roots of contemporary Russian society, to explain disappointing backwardness that Russia systematically experienced on its historical path. The political nature of early Russia was strongly influenced by the Mongols who introduced an autocratic way of ruling with a dominant centre and voiceless territories that was employed by Russian rulers for many centuries afterwards – Tsarist Russia of the 18-19<sup>th</sup> centuries, Soviet Russia of the 20<sup>th</sup> century and also Putin’s Russia of the 2010s were and are equally centralised administrative states with underdeveloped elements or a veneer of democracy. The other side of autocracy was always weak property rights of any peasant, landlord, merchant or industrialist who may lose its assets any time on the wish of higher authority. Even personal freedom of Russian people was quite limited in the form of serfdom in Tsarist era and in various forms in Soviet time (labour camps, collective farms, migration restrictions, etc.).

The voluntary character of autocratic rule gave birth to a special legal regime in Russia where the requirements of the law was such demanding that nobody could comply with them without extreme costs, and a mechanism of selective and demonstrative legal repressions against its opponents. This legal regime is still valid in contemporary Russia and used by the ruling elite for controlling of its business and political opponents.

Another “other side” of autocratic state became the large social class of bureaucrats trading unconditional loyalty to state authority in exchange for an implicit right to take bribes and to embezzle state resources. The bureaucratic class created as an instrument of administration became a powerful player of its own, being able to frustrate any unwanted reforms and to stimulate corruption-friendly ones. Eventually, it is this unproductive and morally corrupted class that historically nullified all positive achievements of the imperial and autocratic development.

Drawing on the past history, we suggest the following traits of Russian economic practices: 1) national pride built and reinforced during centuries of imperial expansion and major symbolic victories in great wars (especially the Napoleonic wars and World War II); 2) collectivism of ordinary people developed in risky agricultural conditions or imposed by the state from ideological and economic motives, and a special form of cynical individualism as a response to unproductive, compulsory collectivist institutions; 3) patience, obedience, and fatalism cultivated by the Orthodox Church and reinforced by the autocratic state and the lack of legal protection of rights and freedoms; 4) inability to pursue daily work according to a rhythm and schedule, but the ability to demonstrate intensive, short-term bursts of energy necessary for survival (believed to be a consequence of the short summer growing season and long winters that immobilised working activities); and 5) high value on interpersonal relationships as a key survival strategy in the context of economic and political oppression by tsarist landlords or Soviet managers.

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