Major Vectors of Institutional Transformations in Russian Economy

Introduction

The 1998 crisis made it possible to analyze the progress of events in the process of reforms and determine with a greater degree of certainty the real development prospects. Two significant stages of the reform process have already been completed. Each of them ended in a severe crisis marking the completion of the stage, after which the prevailing trend in the transformations would considerably change.

The first stage (between 1985 and 1991) saw political liberalization, the soviet political and ideological systems were dismantled. Transformations in the economy were occurring more or less spontaneously. When the overall goal of the first stage was attained, the period ended in the coup of 1991 and Belovezhsky Accords which led to the collapse of the Soviet Union.

At the second stage (between 1992 and 1998), economic liberalization was under way and the soviet economic system was disassembled. This task was also successfully resolved. In August-September 1998 the stage ended in a severe economic crisis which was aggravated by political reshuffles being an inevitable consequence of the radical deterioration of the economic situation.

What the nature of the next stage which started in late 1998 is going to be is a key question the answer to which should be given already today. The current financial and economic problems are undoubtedly extremely complicated. Moreover, solutions have not yet been found to many of them. Meanwhile, the financial shocks are determined by structural disbalances of a more profound nature. Therefore, the next stage may (and most likely, even must) become a period of institutional transformations and institutional construction. This does not mean that no significant institutional changes took place during the previous stages, but the implication here is a shift in the dominant.

Creation of more effective market institutions involves a lot of diverse elements. In particular, it includes consolidation of legal and regulatory framework for the reforms, a change in the governing role of the state and consolidation of the state power; restructuring of enterprises and formation of an efficient owner, development of a new financial and credit system and channels for investments; setting up a developed market infrastructure; promotion of the culture of business relationships and strengthening of trust between economic agents; reformation of labor relations and creation of social security system for employees and the population; improvement of Russian federalism and the relationships between the Center and the regions.
A top priority issue is to develop the institutional forms for the interaction between the state and emerging Russian markets. Three basic points deserve particular attention in this connection:

- the specifics of the institutional approach to the analysis of the state and the market;
- the current status of governmental and market institutions;
- major trends in institutional changes.

When describing the latter we shall take into account the changes which may already be observed today and are apparently of a long-term nature. The empirical material illustrating the current state of the Russian economy appeared as the result of our surveys.¹

The Market as an Aggregate of Institutions

**On the market transition.** Today nobody doubts that this process is absolutely necessary for Russia. The opinions differ mostly about which model to be chosen and implemented is better suited. Presently, the "market transition" has turned into a rather abstract concept when it is not really clear how the "market" is understood and what is to happen when we finally make such a transition.

**On the understanding of the market.** In the traditional economic theory the market is understood as an aggregate sum total of individual exchanges and, secondly, a relatively autonomous sphere with a built-in mechanism of self-regulation.

A reorientation to institutionalism which may be observed in economic research and policies necessitates the development of alternative concepts of the market. The alternative approach treats the market as an aggregate of institutional restrictions narrowing the activity of economic agents.

The underlying idea is to follow how institutional forms are structured in the daily interaction of entrepreneurs, employees, and consumers; specifically, study how access to resources is exercised and how the activity of economic agents is controlled; which relations are formed between them and representatives of state authorities and power structures (including criminal ones); how a network for informal exchange of services is taking shape, how the ethics of labor and business relations is developing. Answers to the above questions give an idea of the market vehicles.

**On the status of market institutions.** It is common knowledge that the legal and regulatory framework of the Russian economy is far from being perfect. The procedure of adoption of a vitally necessary law is dragging for years. But more importantly, the adopted

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¹ The empirical data for the research was based on two surveys of Russian entrepreneurs held by the Center for Political Technologies (headed by I.M.Bunin) in 1997-1998 with the participation of the author and the support of the Center for International Private Enterprise (CIPE). During the first survey 227 questionnaires were collected from entrepreneurs from 21 regions of Russia. In the course of the second survey 96 detailed interviews with entrepreneurs were recorded. See the results of the survey in greater detail in: V.V. Radayev. Formation of New Russian Markets: Transactional Costs, Forms of Control and Business Ethics.-M: Center for Political Studies, 1998.
laws are often not enforced. Both entrepreneurs and the population treat them with an obvious neglect. Most entrepreneurs questioned by us stated that they prefer to abide by the laws "when it is possible", that is, if laws do not become an obstacle to the activity of the enterprise. Moreover, according to the Ministry of Antimonopoly Policy and Business Development, representatives of state bodies tend to violate fundamental constitutional principles and the federal legislation.\(^2\)

A vivid illustration of non-abidance by formal regulations is tax evasion. According to official data, about two thirds of the Russia citizens who must declare their income in Tax Inspections are not doing so. On the average, about one fourth of personal incomes is concealed and not included into the taxable base. Against this background, delayed payments for communal services by the population seem to be quite a logical element of the entire picture.

Tax evasion is even more widespread in business activity. According to our survey, 84% of entrepreneurs consider it as a major violation of legal norms; 10% point out other financial breaches which apparently also relate to tax evasion. According to the estimates of the Working Center for Economic Reforms under the Government of the Russian Federation, only 1.5% of Russian enterprises pay all taxes in due time and in full amount. About two thirds conceal part of their income, while about a third of enterprises evade tax payments altogether.

Thus, this has become a round-the-mill phenomenon. It is considered quite legitimate both from the standpoint of entrepreneurs and public opinion not to pay taxes in full. Speculations on a back-breaking tax burden and the roguish essence of the Russian state have turned into generally accepted justifications. Cheating the state is becoming a working standard. This means that a decrease in the tax level and improvements in the mechanism of tax collection are unlikely to lead to an immediate improvement. Tax evasion has turned into a routine, a justified and, moreover, necessary element of efficient business strategy.

The transition from "a deficit economy" to "non-payment economy" having taken place in the past decade has determined a new framework for the business behavior and formed respective informal strategies of the major business agents. On the one hand, no less than half of businesses are formally loss-making. On the other, this does not prevent them from "privatizing" (i.e. misappropriating) part of the income. Such "flexible" informal strategies result in getting hold of assets, while liabilities are disburdened upon the state either directly, or through chains of arrears.

This may be largely accounted for by the fact the rights of ownership in the Russian economy are not clearly defined. Vague intermediate forms are dominating: there is no clear-cut watershed between the state-owned property and that owned privately and corporately. Most often a piece of property belongs to a certain agent, is used by others, while

responsibility rests with no one at all. Insofar, it is essential that entrepreneurs themselves are often interested in such lack of clarity in ownership relations.  

Informal strategies which are currently elaborated have a rather limited time horizon. The notorious deficit of investments into the real sector is caused not only by lack of funds, but also absence of long-term economic orientation of the agents in possession of such funds. The 1998 crisis demonstrated this particularly strongly. The most "advanced" and seemingly financially powerful group - the commercial banks - proved to be a formation of major profiteers without any sufficient incentives for long-term investments.

The development of long-term strategies is also hindered by a relatively backward underlying market infrastructure, specifically, legal and auditing support, information services and professional education and training. Such a situation is determined by a low demand in these services, which is explained not only by lack of free funds, but also lack of understanding that such services are necessary. There is a certain negligent attitude to expertise which hinders the growth of professional culture. Though the phenomenon may be accounted for not so much by the self-assurance or ignorance of an entrepreneur, but rather the unwillingness to disclose the accounting secrets to outside organizations.

Formal regulation of horizontal relationships between business agents also encounters many difficulties. Business contracts are often breached with references to "objective difficulties". The degree of uncertainty in business relations is extremely high. According to our survey, 82% of top managers experience breaches of business agreements in their day-to-day business activity (32% come upon such breaches frequently). This undermines mutual trust and causes additional costs of at least two kinds:

- transactional costs for gathering information about the reliability of partners;
- alternative costs relating to occasional loss of profit and inadequate allocation of resources.

Third persons (courts of arbitration, public associations) fail to effectively protect businesses from unreliability and lack of integrity. Therefore, "horizontal" forms of supervision over the process of drafting agreements and implementation of undertaken commitments which are currently organized directly by participants in business operations are gaining importance.

Enforced sanctions are becoming most relevant for such supervision and protection of rights of ownership and own interests of participants in the market. According to our survey, 42% of Russian managers experience pressure from the position of force, and often they become objects of extortion by force (3%), while 58% of the respondents have never found themselves in that kind of a situation.

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4 V.V. Radayev, Formation of Emerging Russian Markets: Transactional Costs, Forms of Supervision and Business Ethics, p.117.
There are grounds to believe that former racket has given way to more developed forms of control which, apart from "protection of business", is related to investment of capital and provision of business services. Violence has gradually become a routine phenomenon - coercive methods have turned into a "regular" element of business life. For that matter, the ethics of observing business agreements largely depends on the balance of forces which stand behind entrepreneurs. Direct violence may not be used, however, explicit and implicit references to a possible interference "from the position of force" are an important way to strengthen contractual relations.

Therefore, there is quite an extensive area for an institutional reform.

**Trends in institutional changes.** One should not really hope for a time when Russian economy in some ten to fifteen years will turn into an economy of a formal contract backed up by force of law and efficient activity of "third persons" exercising judicial and arbitration functions. The personified connections prevailing over generally accepted formal law are not the relationships which may possibly be changed within a single life-time. Thus, in many aspects the Russian economy will remain informal. Nonetheless, significant internal changes must take place. Informal economy exists in two dimensions, specifically:

- the informal sector of the economy as opposed to the formal one;
- informal business relations not recorded either in laws or in accounting books and permeating all types of activity.

One could expect that the informal sector will be diminishing with time. Obviously, what is to take place, if not the shrinking of the informal sector, is a more clearly defined localization of purely criminal segments of the markets (sales of drugs, weapons, etc.) and a semi-legal "grey" economy. As for informal relations within all sectors, without any exceptions, they will not lose their crucial role.

The problem of tax evasion will continue in future. Lower tax rates proposed by many politicians, entrepreneurs and experts, may ease the conditions of business activity, but the level of tax collectability is unlikely to go up considerably, at least in the foreseeable future. The reason is that non-payment of taxes to the government has already become an established routine of business life perceived as a norm. As mentioned above, non-payment of taxes by many agents is regarded as a quite justified and legitimate matter, moreover, the generally accepted opinion has it that it is just impossible to go on to exist while paying all the taxes. Tax benefits are not going to help in overcoming the habit-like norm of behavior. The problem could be resolved not through tax rates manipulation (though, indeed, many of them need to be decreased), but by considerable simplification of the tax system and stage-by-stage build-up of control over tax collection.

**Mixed economy** is being created, but gradually. However, it does not conform to the system which was so often discussed in the past decade and which presupposed a co-existence and competition of different sectors of the national economy: the public, shareholder, cooperative, and private one. There are no marked boundaries between them. Vice versa, the domination of mixed forms is getting stronger, and at times it is impossible to determine whether an enterprise is state-owned or not, whether property belongs to shareholders or is privately owned. The rigid delineation between forms of ownership proves to be too formal and a far cry from real life.
As for the *key sectors* of economy, two major formations may be singled out: on the one hand, large business organizations striving for oligopoly positions (and quite successfully) in their respective spheres and closely bound to the state. On the other hand, "green field" strata of entrepreneurs, i.e. small businesses and individual entrepreneurs operating mainly to satisfy the demand of local markets.\(^6\)

A top priority issue for future reforms is *restructuring of enterprises* from the aspect of ownership rights and organizational structure. As desirable movements we would single out the process of merging into large corporations and the creation of investment holdings on the basis of viable large-scale businesses. The shares of the above structures should be open to external investors and accessible to the population. At the same time, possibilities for speculative use of raised funds should be restricted, while the chief function of these institutions should be to invest into the head enterprise and the systems servicing it.

Such a system will be difficult to implement without expanding equity participation of government bodies (federal, regional or municipal ones depending on the scale of enterprises). Such measure should be aimed to build up the confidence of major and retail investors and allow the state to exercise efficient supervision over the activity of such holdings. A scheme like that combining real production, openness in terms of raising borrowed funds and government control over the use thereof will make it possible to gradually resolve such tasks as encouraging investments in the real sector of economy, reviving confidence in financial institutions and mobilizing free money.

From an organizational standpoint, we have in mind more flexible models for the internal division of major firms, separation of relatively independent small enterprises therefrom, establishing of diverse ties between enterprises of various scope and forms of ownership, and creation of effective combinations of large-scale and small businesses. At the same time, the goal of the latter will be not the appropriation of funds belonging to agonizing giants for the benefit of certain individuals, but servicing big business through flexible systems of subcontracts, franchising, and etc.

Big and small business differ not only in conditions of functioning, but the level of *economic culture*. Managers of major enterprises were fairly well educated under the soviet era too. In future, "leaders of business" will have more specialized education, not only technical, but also economic, financial and managerial. Small business in this sense may find itself in a more difficult situation, that is why it will be necessary to carry out large-scale (and sponsored) programs for education and training of entrepreneurs of small business in the fundamentals of economics and commercial law.

An essential element of economic culture is *business ethics*. It would be too naive to hope that in ten to fifteen years all entrepreneurs will be guided by universal code of conduct. However, the process of business ethics formation is already under way. Organization of professional business communities uniting entrepreneurs engaged in similar businesses and

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business unions, as well as permanent business partners contributes to this process. In future such structures should assist in exchanging information and providing mutual services, establishing good will. Good will and reputation are to become an essential element adding to the possibilities of an entrepreneur to act "from the position of force", and with time a major condition for business contacts.

The area of application of power methods will apparently be shrinking. This, however, does not mean that criminal elements will disappear from business life. This rather implies a change in the nature of business criminalization. The main zones of influence have already been divided and real power is resorted to only in the event of serious violations and review of zones of influence.

Criminal structures are now not only engaged in "money laundering", but also have to accept many rules of an "honest business" game. Bold "onsets" are more and more becoming the sphere of "accidental tourists" and desperadoes. Organized crime tends to turn into a business enterprise.

Revival of confidence in economic institutions is rightfully considered a major problem of the institutional environment. For this goal to be attained other institutional structures and new system of guarantees are needed. A most painful example is the loss of personal savings. Retail investors found themselves defrauded several times during the years of reform, most often that happened due to lack of transparency of the banking system and the stock market. Today high-flown statements and agitated advertising campaigns fail to produce the same effect as they used to in mid-1990s, the era of flourishing financial pyramids. At the same time, inevitably institutions should be developing in accordance with a more or less clear-cut specialization. For instance, settlement centers (such as non-banking credit organizations) should be separated from investment institutions (banks and funds) engaged in investments involving certain risks. In the latter category speculative institutions offering riskier investments with higher interest rates should be singled out. A possibility to make an informed and conscious choice is a step towards strengthening confidence. The second step should involve the building of the system of guarantees (primarily state guarantees, for, alas, nobody will trust any other). This calls for a solution of a more general problem of state consolidation.

The State as an Aggregate of Institutions

At all stages of institutional reform the key role has always belonged to the state. In the late 1980s, the state provided relative freedom for the developing entrepreneurial activity, and in early 1990-s confined the latter to rigid financial and economic boundaries. Today for purposes of entrepreneurship it is necessary to form a more favorable institutional environment where government agencies will again be central.

On the state versus the market. Such opposition has become a rather fixed stereotype. Either the actions of the state are viewed as external restrictions and an abstract

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system for regulating conditions of business activity, or the state is regarded as an economic agent pursuing its own goals, similarly to individuals and firms. We believe that the neglect of an active economic role of the state, as well as the confusion of the state with "rank-and-file" market agents seriously hinders the elaboration of a new concept of transforming markets. Representatives of the state act as direct, though special agents at most of emerging markets.

When the role of the state is discussed many questions arise, specifically about whether the state should or should not get involved in the economy and within which boundaries; whether prices should or should not be controlled, and in which specific areas; whether certain taxes should or should not be introduced. In such discussions the state is perceived as a monolith, a single agent pursuing its policy, or which is worse, an instrument in the hands of a group of reformers in whose direction various comments and remarks are made (as a rule, most unflattering). Meanwhile, the power of the state is exercised through a complicated aggregate of dimensionally and hierarchically arranged institutions and organizational structures. Representatives of the state exercise supervision over the activity of enterprises, collect taxes, regulate access to resources, provide selective support, ensure protection of economic resources. These representatives most often pursue their own micro-policy. Close attention should be given to the micro level where day-to-day relationships are being formed between enterprises and structures of state management.

**On the state impact.** The fact that the Russian state has formally assigned many rights of ownership in favor of enterprises does not at all mean that it "has withdrawn from the economy". The weak state remains large enough. The burden of administrative control is still heavy. According to our data, only half (51%) of enterprises have administrative inspections not more than once a month (less frequently than once a month - 26%), more or less equal groups are made up of those enterprises who are inspected 1.5 and 2 times (22%) and 3 to 5 times (21%), while 6% of enterprises are inspected over 5 times a month.8

Is that many or few? According to a comparative survey of retail trade enterprises which was conducted in Moscow and Warsaw, the number of administrative inspections in Russia is twice as high as in Poland (the average figure of 18.5 versus 9 inspections per year). This is certainly just a small fragment of the overall situation. But apparently the Russian conditions are not particularly favorable in this respect. The main thing though is not the number of inspections, but the fact that while destabilizing the activity of enterprises inspectors most often fail to exercise the due controlling functions and eliminate causes for numerous violations.

Administrative inspections are often associated with bureaucratic extortions. The data from the survey of Russian entrepreneurs shows that about 64% of managers have personally encountered such situations in the course of their business activity, among them 20% have faced them frequently (35% have not experienced extortion at all). At the same time, every

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fifth entrepreneur thinks that it is quite feasible to eliminate corruption in the Russian business in the near future."

This means that government agencies have not refused to interfere with the business activity of "their" enterprises and a system of benefits for them. Insofar, the efficient control over the activity of enterprises (including those which formally remain in state ownership) has been actually lost. Non-privatized property is thieved away as successfully as that privatized.

Tax and administrative pressure of government structures exerted on operating enterprises helps to, firstly, preserve actual bureaucratic control over the activity of enterprises under the changed conditions. Secondly, it shapes significant elements of business strategies pushing entrepreneurs to enter into informal relationships with representatives of authorities and strive for getting individual benefits and privileges. Thirdly, this pressure causes entrepreneurs to transfer part of the activity into the "shadow" sector. Fourthly, representatives of state power themselves are getting involved in semi-commercial and "shadow" operations.

This results in a situation when government agencies fail to provide an average entrepreneur with the necessary infrastructural support and a sufficient level of security, thus generating vicious circles related to lack of protection and under-funding. In parallel the market of selective bureaucratic services when "problems are resolved" at an informal level is growing.

Under the above situation, trust to government agencies and the business rules set thereby is undermined. There is a drop in confidence to non-government institutions, since, as public opinion has it (which is not always justified), the government is a certain guarantor of obligations undertaken by such organizations. The behavior of retail investors in the situation with "financial pyramids" in mid-1990s and after the 1998 crisis of the banking system is illustrative enough. Claims are always transferred to the state, and it has to assume at least part of liability. All this objectively necessitates institutional transformations at different levels.

**Consolidation of the state.** This process is in store and it will be of crucial importance. This opinion is shared by many. However, the process is understood differently. Some experts tend to believe that it will be tied to a comeback to the communist era, total nationalization, and "industrial policies" of direct subsidies provided to major economic sectors. We believe that the process will be directed otherwise. The state has neither the power, nor funds to engage in large-scale nationalization and provide subsidies, and it does not seem likely that they will appear in the near future.

A method far more effective than nationalization is to enhance control by the authorities over government, semi-government and system-generating non-government structures. The 1998 crisis strengthened the position of government agencies, for the financial system is being rehabilitated with the direct participation thereof. Instead of formal nationalization the management of companies, particularly of major companies, will

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continuously be transferred under the control of regional and municipal administrations. It is common knowledge that the recovery of the banking system in the regions is also exercised through banks authorized by regional authorities. This means that the state will have to partially assume responsibility for the development of major structures placed under its control, and develop a system of state guarantees for the viability thereof.

Funds for direct subsidies will be too limited, therefore, they may be used most efficiently for the development of infrastructure servicing the market. The experience of the last years has demonstrated that organizations engaged in information support, consulting, professional re-training rarely manage to survive when functioning exclusively on commercial principles. This is confirmed by our study of the structures supporting small business in Tomsk oblast\textsuperscript{11}. The participation of the state and foreign donors attracted with its support is necessary for all the above kinds of activity.

Unfortunately, it does not seem possible to overcome the evil practices when authorities provide individual benefits and privileges to certain business agents: they have penetrated too deeply into business relations. Corruption will not disappear of its own accord. Intermittent campaigns aimed to detect and punish bribe-givers and takers will not lead to serious changes. Moreover, such campaigns pursue political goals, as a rule, and are aimed not so much against corruption per se, as against specific political opponents. Insofar, the consolidation of the state cannot come about without a change in the principles for the operation of government bodies. What we have in mind is inevitable (though, most likely, partial) administrative restructuring. Its essence is not structural shake-ups in power bodies, but implementation of the principles listed below:

- a dramatic cut in a number of various bureaucratic authorizations and approvals related to the registration and accrediting of enterprises, licensing of activities; decrease in the number of businesses subject to regulatory restrictions, prolongation of the term of authorizations;
- unification and drastic simplification of administrative regulations of business activity, eliminating non-systematic regulation and restriction of business activity on the part of government authorities at different levels;
- exercise of uniform supervision over administrative authorizations and approvals aimed to prevent further dispersion of power, and a cut in the number of agencies exercising direct control over the activity of an enterprise;
- introduction of elements of competition between bureaucratic structures through granting a possibility to a business agent to receive a certain authorization in different branches of the same government agency;
- restriction of the existing practices of providing commercial services by state government agencies and official services at contractual prices.

In order to consolidate the state, it is also necessary to improve commercial legislation making it more efficient and to constrict out-of-the-law zones. Criminal ("black") and semi-legal ("gray") segments of the Russian markets should be more clearly distinguished.

At this point in time, the trend towards gradual extrusion of criminal and semi-criminal groupings out of the "grey" market segments by state law enforcement agencies and private security structures is already noticeable. This process will be followed by partial de-commercialization of protective functions of the government agencies and the strengthening of control over non-government power structures which will make it possible to limit the opportunities for criminal elements. Preventing dispersion of violence in society will become an essential element for consolidation of state power.

Thus, it is not just a combination, but a closer intertwining of "government" ["administrative"] and "market" methods of control over the production and financial sphere.

**On the policy of institutional transformations.** Institutional reform of the Russian economy is not a matter to be resolved in a year. Therefore, it does not seem really possible to develop a detailed forecast for the development of Russia. The most promising areas for transformations are as follows:

- improvement of legal and regulatory framework, and the vehicles for the implementation of the adopted laws;
- administrative restructuring of state power bodies instead of pseudo-ideological games, struggle for portfolios, and populist campaigns against certain corrupt officials;
- attaining of a more orderly and systematic government control over business activity, restriction of power privatization and commercialization processes;
- restructuring of enterprises and creation of a strata of efficient owners who actively influence the corporate decision-making process;
- encouraging of small business and incorporation thereof into larger corporate and territorial forms of business;
- creation of a developed market infrastructure with institutions providing financial and technical assistance;
- development of specialized channels to attract the savings of the population with a more reliable system of guarantees, revival of confidence in financial institutions;
- rehabilitation of channels to attract the savings of the population with more reliable guarantees against another fraud, and recovery of confidence in financial institutions;
- development of incentives to investments in medium- and long-term projects.

Many of such transformations require time, and even with a reasonable policy dramatic and fast changes cannot be hoped for. However, acute financial and economic problems facing the country should not blot out the necessity to carry out vital institutional reforms. Lack of attention to the above issues, apart from other things, brings down the potential positive effect of macroeconomic transformations. Purpose-oriented development of formal and informal institutional structures and relationships should be made central for the economic policy.