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# Corruption and the crisis

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## Overview

The Medvedev administration's anti-corruption drive has not been derailed by the financial and economic crisis. In December 2008 fundamental and radical legislation was enacted. The new measures cover all aspects of this number one country risk factor but focus on the most important aspect for the investment climate - the state mafia preying on business. The impact of faster small business creation will be more immediate in an environment of incipient recovery from a sharp downturn and labour market loosening.

But what grounds are there for supposing that this new effort can succeed against the background of swelling official extortion and plunder in recent years? The evidence is to be found in the results of a multi-year monitoring of a similar campaign from 2001-06. These survey data show that deregulation initiatives start to work but then the state mafia counterattacks. We believe the Medvedev programme is an accurate riposte - one whose potential is underestimated.

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## Core Case

The financial and economic crisis will increase the dividend from successful anti-corruption efforts, while evidence from previous initiatives suggests Medvedev's drive will live up to its promise.

## Assumptions and Evidence

Multi-year monitoring of previous deregulation efforts shows a pattern of state mafia push-backs, which are now being targeted in the latest anti-corruption drive.

## Core Case

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Dmitry Medvedev has made strengthening the rule of law and fighting corruption the central projects of his presidency, stating that he would like to be judged at the end of his term by progress on these fronts. In our December 2008 report [Judicial reform in the light of the crisis](#), we assessed the Medvedev agenda for the court system and judiciary, concluding that the effort is correctly oriented - towards improving human resources and judicial independence, the factors that can make a difference over time. In this companion piece, we turn to the content and prospects of Medvedev's policy drive in the related, but much broader, areas of corruption and the quality of administration and public goods delivered by the bureaucracy at all levels.

No investor exposed to Russia will need any convincing about the importance of corruption, both for overall country risk and for the many ways it can impair the value of each individual investment. Investors may be disinclined, however, to devote much time and attention to the authorities' periodic displays of political will and announcements of new initiatives on dealing with corruption. For despite many fine-sounding proclamations and some useful policy steps during the Putin presidency, the problem remains chronic, apparently deteriorating and - for the foreseeable future - ineradicable. In his final marathon press conference as president, in late February 2008, Putin's response to a routine question about corruption was one of weary resignation.

Nevertheless, we see three reasons for looking closely at the latest anti-corruption drive launched by Medvedev.

### REASON NO. 1: THE CRISIS PERSPECTIVE

While corruption is a perennial risk factor in Russia, it deserves particular attention during an economic crisis. These conditions increase the importance of progress in limiting corruption as a growth driver.

The type of corruption that matters most for the investment climate is predatory bureaucrats extorting bribes and otherwise hounding businesses. Such officials act either in a principal capacity (making money for themselves from issuing permits and licences, for example) or as agents (using their powers to penalise businesses on behalf of private-sector predators ready to pay for such bureaucratic "services").

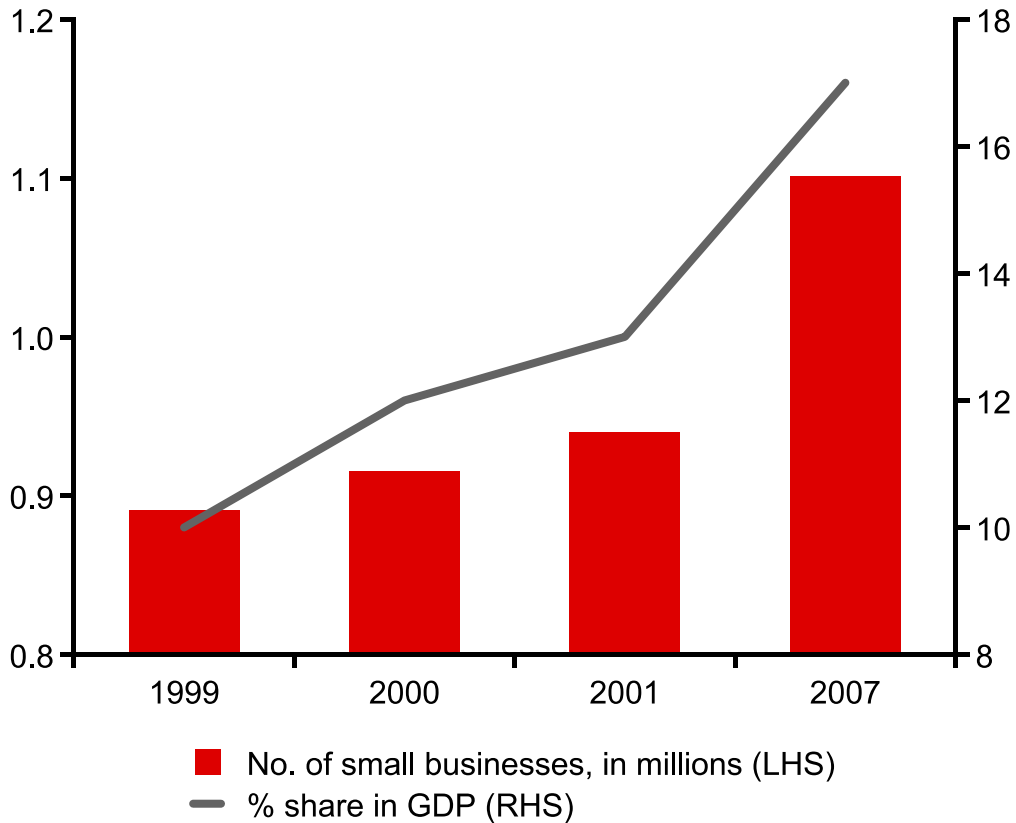
Reining in this state mafia lies at the heart of the new Medvedev anti-corruption agenda. At a big set-piece meeting of officials and small business representatives on protecting SME property rights in July 2008, Medvedev delivered the most famous soundbite of his presidency to date when he called on law-enforcement and other authorities to stop "causing nightmares" for business. That call has become part of Medvedev's political signature, similar to the way Putin made his first impact on the public mind in September 1999 with his promise to "rub out [Chechen] terrorists in the outhouse".

What is the particular relevance of curbing the state mafia to the post-crisis revival of economic growth? In the present fire-fighting phase of crisis management, the "anti-nightmare" campaign is not in the front line. The first condition for overcoming the crisis - and for achieving sustained growth in general - is successful adjustment to external shocks. Adjusting to the present oil price shock on the back of world recession requires policy flexibility, especially towards the exchange rate and the budget. The resulting pain from the economic downturn itself and the associated adjustment policies creates a risk of social and political destabilisation. But if society, institutions and the ruling elite pass this test - a good proxy indicator here is maintaining macroeconomic stability founded on responsible policies - the economy will start growing again.

It is at that point of incipient recovery that corruption becomes a decisive factor. Alongside whatever contribution a recovering oil price makes to revived growth, domestic business activity

will play an important role. In comparison with the last major crisis of 1998, the subsequent development of Russia's economic transition from central planning - notably in the service sector - will make SMEs a more important driver of job creation this time round. The chart below shows both the acceleration of small business development in recent years and the scope for increasing its share in GDP to a realistic level - say, half way between the 17 per cent recorded in 2007 (latest available data) and the OECD region average range of 60-70 per cent.

**Small business in Russia, 1999-2007**



Sources: Kremlin website (kremlin.ru) and TS estimates.

With tight credit and sluggish demand making the going hard, acceptable business risks will be all the more important for the development and creation of SMEs. Anything that helps get the state mafia off the backs of entrepreneurs will have a particular impact as the economy pulls out of the downturn that began in Q4/08 and could last for anything between two and six quarters, depending on the depth of the oil price fall

## **REASON NO. 2: THE NEW PUSH IS FOR REAL**

### **Police mafia tackled at last**

The single most striking piece of legislation against the state mafia in Russia's history was signed into law by Medvedev on 26 December 2008. Federal Law No. 293 bans ad hoc inspections of businesses by the agencies of the Ministry of the Interior (that is, police raids on companies, to which small entrepreneurs are especially vulnerable). Perhaps the most important detail of this new legislation is the provision that the police are no longer authorised to go after businesses (confiscating documents, impounding vehicles and equipment and so forth) on grounds of suspected tax violations. This change and various other provisions aim at reducing or eliminating police powers of initiating action against entrepreneurs.

The scope for such "initiatives" by the police - combined, of course, with their fundamental capacity for legal violence - has made it easy to shake down businesses (typically with the police acting as paid agents of corporate raiders). From now onwards, police dealings with business will be confined to a supportive role in processes initiated by regulators or prosecutors. For example, police involvement in tax-related matters will be limited to accompanying tax service officials, at the latter's request, during routine inspections or special investigations. The law also defines procedures for ensuring that when documents are required or seized in the course of inspections, companies can continue to operate normally in the meantime.

There could be no more conclusive demonstration of political will than this law. Particularly interesting has been the testimony of officials in the Economic Development Ministry and legislators in the State Duma who led the drafting and enactment of this legislation indicating that they were supported every step of the way by senior officers in the Interior Ministry. This shows that the problem of the police mafia has reached such proportions that denial - the instinctive reaction of the police (or any other) corporation to external criticism - is no longer an option. For many years, opinion polls have shown that of all the country's institutions, the Interior Ministry (i.e., the police) has the highest rating of public disapproval and distrust.

So, despite the distractions of war against Georgia and a full-blown financial and economic crisis, the Medvedev team has managed to move quickly from words to deeds in the first months of his presidency. Moreover, Medvedev signed two other major pieces of legislation at the same time as the law reducing police powers.

### **Fresh counter-attack on predatory inspections**

The first of these was Federal Law No. 293, which protects companies and entrepreneurs from the predations of all the various regulators and supervisory agencies that have powers of inspection. In contrast to the law on the police, which addresses a specific evil, this new law on inspections aims to be a more systematic antidote to the poison of corruption in the Russian business world. The law builds on two previous pieces of very similar legislation enacted in 2001 and 2003. This story of continuing efforts to reduce the scope for extortion by official inspectors is examined in detail below for the evidence it offers about the potential for real progress in this crucial area for the business climate and hence overall economic performance and investment returns.

## A new anti-corruption synthesis

The second of the two other major anti-corruption laws signed in December 2008 was "On combating corruption" (Federal Law No. 273), which provides a statutory framework for the anti-corruption programme published six months previously. The programme includes some important innovations (detailed below). But its most important feature is that it draws together the threads of all the various anti-corruption initiatives that emerged during the Putin presidency. This a good place to step back and take stock of overall anti-corruption policy, which consists of two fundamental components.

### A. Regulation

This first component could perhaps be more conveniently labelled deregulation because in practice it involves more than restricting or abolishing powers and functions that lead to bureaucrats soliciting or being offered bribes. Almost as important is the simplification of the regulation that remains so as to enable good-faith compliance. The need for this goes back to the Soviet period, when the surface content of most regulations camouflaged their true function as instruments of intimidation, extortion and control. This was achieved by contradictory provisions - making violations inevitable - or by setting impossible standards.

The most concentrated incidence of this corruption mechanism is to be found in the area of quality standards. While most of the 27,000 so-called state standards (Gosstandarty) now in force date back to the Soviet era, a sizeable number has been drawn up since then (including some as recently as 2008). The regulatory basis for fire safety, for example, comprises more than 2,000 normative acts stipulating a total of 150,000 conditions that must be met by all businesses and organisations and in all public buildings. To take another example among hundreds, the standards to be complied with when opening a new works canteen would be unattainable even in a money-no-object luxury hotel.

The Putin administration set about replacing the system of Gosstandarty with so-called technical regulations. The plan has been to draw up sector-specific quality requirements that are simple, practicable, consistent and limited to health and safety issues. Each set of new technical regulations for one or another group of products or services is to have the status of federal law, preventing bureaucrats from arbitrarily rewriting and complicating the requirements. The 2003 umbrella law which enacted this plan called for all the new technical regulations (that is, hundreds of separate new laws) to be enacted in the following seven years. More than five years later, a mere three technical regulations have reached the statute book (on car emissions, petrol content and foods containing vegetable oils and animal fats).

### B. How regulation is applied: The bureaucracy ...

This other main area of anti-corruption policy shifts the focus from the regulations themselves to how they are applied. The real subject here is the bureaucracy - which cannot, of course, be wished out of existence however much desirable pruning and simplification of regulations is achieved. Hence the need for carrots and sticks not only to make officials less corrupt but also more efficient as they go about their work.

This standard label for this whole area is "administrative reform" - that is, improving the quality of the state administration. This for Russia is the reform of reforms. No chain is stronger than its weakest link - namely, the state administration, described by Putin in various speeches towards the end of his presidency as a "heavily bureaucratized and corrupt system" staffed by a "haughty caste" of officials and lacking "the motivation for positive change, much less dynamic development".

### ... bureaucratic structures ...

One strand of "administrative reform" was a reorganisation in 2004 of federal government agencies into three self-standing categories: those that make policies and write rule books; those that apply those rules (all kinds of regulators and inspectors); and pure service providers. Ever since, "administrative reform" has tended to be associated only with this particular initiative, which proved to be a fiasco and was formally abandoned with the formation of the new government in May 2008.

### ... bureaucratic standards and ethics ...

Besides improving bureaucratic structures, there are two other important (and more promising) aspects of administrative reform. The first of these might be labelled pure civil service reform. Early steps in this area date back to 2002, when Medvedev - at the time a senior Kremlin staffer - coordinated new framework legislation on the civil service and a code of conduct for public servants. The new anti-corruption programme returns to that agenda, by establishing enforcement units within agencies, whose remit will include implementing rules on conflicts of interest introduced in 2007.

But the programme also includes some brand new measures, which amount to a radical improvement in civil service transparency:

- Compulsory declaration of incomes and assets of officials and their immediate families, combined with new powers for enforcement bodies to verify these declarations by means of investigations and physical searches;
- Confiscation of embezzled property;
- Reducing or eliminating immunities and special procedures that now apply to various categories of official suspected of wrongdoing;
- The disqualification of officials violating anti-corruption rules and procedures from future employment in the public service and a ban on recruitment to the police or civil service of individuals who have criminal records or have been under investigation without their names being cleared (even if no charges were brought).

### ... bureaucratic procedures

A final aspect of administrative reform (besides reorganising the bureaucratic structure and raising civil service standards) is that it serves as a natural extension of the entire regulatory reform bloc. It involves tightly defining the procedures that officials must follow in exercising their regulatory powers, thus preventing them from inventing and altering procedures - not to mention arbitrary "fees" - to please themselves. This challenge is even wider and deeper than bureaucratic extortion from business, since at stake here is the delivery of public goods and services to the whole population and reducing the deep-rooted alienation of people from the state.

This effort was at the centre of the government's administrative reform strategy adopted in October 2005. Since then, the government commission on administrative reform has been drawing up procedural codes that minutely define the procedures to be followed by state agencies that deliver services such as the registration of companies and land ownership title or the issuing of licences and permits. So far, some 400 such sets of procedures have been adopted and are being implemented by agencies like the federal migration and registration services. Another 1,000 are currently being worked out. In all, a total of 2,500-3,000 are planned for implementation at both the federal and the regional level.

Above all, the regulations on administrative procedures are aimed at establishing the accountability of officialdom. By rigidly laying down who is responsible for delivering each aspect of any service, the new regime paves the way - at least in theory - for legal recourse. However, a very important feature of the new regime would, in itself, pre-empt most litigious leanings: no fees are to be charged for any service delivered unless stipulated in federal law.

An enhancement of this area of administrative reform was the 2007 launch of the realisation of the "one-stop shop" principle. The plan is to build so-called multi-functional centres - or "supermarkets for services", as they have been dubbed by the Russian press - throughout the country over the next few years. Several such centres are currently being tested in 16 regions.

### **REASON NO. 3: ACTING ON EVIDENCE FROM PREVIOUS INITIATIVES**

The final reason why the new anti-corruption drive deserves attention is a fascinating body of evidence drawn from previous initiatives to rein in the state mafia dating back to Putin's first term. The practical impact of those earlier initiatives was measured in a multi-year monitoring programme in seven regions carried out by the Centre for Economic and Financial Research (CEFIR, a leading Moscow economic think tank) with financial support from the World Bank. These results provide a sound basis for judging the likely effectiveness of the Medvedev administration's plans.

The CEFIR monitoring study was prompted by the first wave of legislation designed to reduce bureaucratic pressure on business. This legislative effort began in 2001 and was led by then Minister of Economic Development and Trade German Gref, with the assistance of, among others, his successor, Minister of Economic Development Elvira Nabiullina. Three pioneering laws enacted in 2001-02 targeted the most fertile opportunities for extortion by officials: the registration of new companies; the licensing requirements attached to many different type of business activity; and inspections of businesses by officials from the tax service, fire and hygiene safety inspectorates as well as a host of other agencies.

The table below shows these laws leading to subsequent legislation in the same areas during the rest of the Putin presidency.

Law	Date entered into force
On inspections	August 2001
On licensing	February 2002
On registration	July 2002
On certification	June 2003
On inspections	October 2003
On registration	January 2004
On licensing	January 2007
On self-regulating organisations	December 2007

Source: kremlin.ru.

The repetitiveness of this list is significant for its relation to the core finding of the CEFIR study. The monitoring of the implementation of these laws in seven regions coupled with panel data on companies' experience shows two things:

1. Legal constraints on bureaucratic predators begin to have the desired effect within two years of their introduction.
2. But, starting from year three, the state mafia pushes back, finding ways to circumvent these constraints and continue extortion (often more brazenly and intensively than ever).

## **Inspections: Targeting the unscheduled variety**

This pattern can be illustrated with reference to inspections, which were the subject of the very first deregulation law in 2001 and of the more recent legislation described above (Federal Laws Nos. 293 and 294).

In Russia today, there are no fewer than 30 federal agencies empowered to carry out inspections of businesses, while a total of 45 types of control exist at the federal level alone. An estimated 20 million inspections took place country-wide in 2006. The August 2001 law on inspections stipulated that each of the inspection agencies carry out no more than one scheduled inspection every two years. The subsequent 2003 law on inspections introduced a tighter rule whereby the first inspection of a new business take place no earlier than after three years of registration. Within less than a year of the 2001 law entering into force, the number of inspections by the tax authorities, the fire safety and sanitary agencies and the police - the agencies that most frequently carry out inspections - had fallen by 26-30 per cent, while those by the licensing and certification agencies more than halved. Since then, the rate of reduction has slowed, with inspections by the fire safety authorities still exceeding the number permitted under the current law.

However, all those restrictions applied to routine scheduled inspections. No provision was made for the unscheduled probe - which, sure enough, accounted for a higher percentage of the total number of inspections in 2006 (the last year of the CEFIR survey) than in 2002. The police bucked this trend, insofar as more than 60 per cent of all inspections carried out by the police in 2002 were unscheduled, but that figure had dropped to just over 50 per cent in 2006. However, this modest fall seems insignificant since it comes from such a high base - in itself reflecting the reality that the police constitute the core of the state mafia.

Against this background, the importance of the new Medvedev laws becomes clearer than ever. The abolition by Federal Law No. 293 of police powers to harass companies (especially small businesses) is a major advance. As for inspections, the new law (No. 294) counters predators' stratagems in two ways:

1. It closes a loophole inadvertently left by the provision of the 2001 law limiting the frequency of scheduled inspections. That provision was circumvented by different agencies carrying out inspections to verify companies' compliance with one and the same norm. The new law also limits the duration of inspections to 70 hours and in the case of businesses with up to 15 employees no more than 15 hours.
2. Crucially, it prohibits unscheduled inspections of businesses unless sanctioned by the prosecutor's office.

## **Licensing: Further reductions, replacement with self-certification**

The provisions of the new law on inspections extend into the equally fertile field for state mafia activity of business licensing and permits. Particularly vulnerable sectors here include hospitality, retail and wholesale trade as well as passenger and freight transport.

The CEFIR study once again reveals the bureaucracy finding new ways to extract rents in response to old ones being closed off (the February 2002 law reduced the number of activities subject to licensing from 400 to 100, while a second law in force since January 2007 further halved that number). For those activities for which licences have been abolished, licensing has been replaced by a system of third-party liability insurance and self-regulating organisations (for which the framework law entered into force only in late 2007).

Since the existence of a licensing requirement is a black-and-white matter, officialdom has reacted to this liberalisation by making it harder for companies to obtain licences for activities that are still subject to licensing. CEFIR shows that companies spent an average of 14 days obtaining a licence in 2006, compared with nine days in 2002. Meanwhile, the average time lapse between applying for and receiving a licence grew in that same period from 30 days to 32 days.

Another bureaucratic innovation not picked up in the CEFIR study but highlighted by Medvedev himself in his various speeches launching the new anti-corruption drive is the system of "legalised bribery". This involves permitting requirements nowhere to be found in federal legislation but arbitrarily imposed on small businesses before they are allowed to start operating. Local authorities frequently make permitting conditional on companies obtaining a positive "opinion" from a named consultancy - which, of course, will be owned (usually through a relative) by the officials giving out the permits. The new December 2008 inspections law establishes for the first time the right of companies to submit self-certification of compliance rather than having to obtain permits.

The Medvedev administration has further plans on this licensing front. These include a radical scheme to replace some remaining licensing requirements with insurance cover. A specific law for the construction industry (replacing licences with accreditation from self-regulating organisations) was adopted in June 2008 but will not enter into force until 2010. Under a bill submitted by the government to the State Duma in July 2008, the list of some 1,400 products for which quality and safety certification is required could be slashed almost by half.

## CONCLUSION

The financial and economic crisis has taken its toll on the Medvedev administration's anti-corruption effort. For example, First Deputy Prime Minister Igor Shuvalov has had more pressing priorities since he stated his commitment in September 2008 to finalise the slimmed-down technical regulation on fire safety standards by year's end. In his second decree as president (dated 7 May 2008) - on the allocation of idle state-owned land for housing construction - Medvedev ordered that all technical regulations on the safety of buildings, installations and other structures be passed by 1 January 2009. This deadline was never realistic, given the enormity of the task. And it will come as no surprise that in the present environment, the implementation of Medvedev's decree has stalled.

Yet, as the above discussion shows, the crisis has not derailed some fundamental and even radical legislation. Above all, thanks to the monitoring evidence for the period 2002-06, we have an excellent perspective on Medvedev's campaign to improve the business climate by controlling the state mafia. What emerges from the CEFIR survey is that such a task is not unlike a tennis game in which government deregulation initiatives alternate with counter-volleys from the state mafia but, as the rally progresses, the area of the court in which the state mafia can play becomes progressively smaller. The conditions for success on this front are clear: a combination of political will and, with each round of legislation, a precise focus on squeezing out the scope for extortion revealed in bureaucrats' response to the previous round. There is no doubt that the Medvedev programme meets those conditions.

As will be clear by now, Medvedev's anti-corruption programme extends well beyond specific business climate problems. Alongside extorting from business (and from private citizens), a still vaster field of corruption is, of course, officials simply plundering taxpayers' funds. For all its scale, this area of corruption is less damaging to Russia's potential rate of economic growth, since the proceeds of theft are largely recycled into domestic consumption (at any rate, a lower portion of such proceeds will be transferred offshore than was the norm in the 1990s). But the government's new programme pays close attention to this area, notably in the fields of state procurement and the management of state and municipal property.

Another aspect of the anti-corruption cause that we have not dwelt on in this report is even more basic: repression. No one - least of all the Russian public - takes seriously the arrest and

prosecution of corrupt officials; and the more senior the officials in question, the more widely it will be assumed that they have been targeted for a reason far removed from impartial law enforcement (and most likely to do with some settling of accounts between conflicting bureaucratic-business clans).

Nonetheless, the fact is that the last two years have seen a huge increase in corruption-related prosecutions. Figures for 2008 released by the Prosecutor's Office show that 8,625 people were convicted on corruption charges, including 1,600 law enforcement officers (the largest category, alongside doctors and teachers), 1,000 bureaucrats and 250 mayors. Interior Ministry figures more usefully offer comparisons with previous years. In 2008, 13,000 bribery cases were opened, of which 9,800 went to trial in the courts, with 6,000 individuals indicted (those figures represent a year on year increase of 43 per cent, 29 per cent and 47 per cent respectively). These numbers reflect a realisation by the political leadership that regulatory and civil service reform needs to be bolstered by re-instilling the fear factor into the ranks of officialdom.

In a speech to regional legislators in July 2008, Medvedev was eloquent on this subject of officials' insolent sense of impunity:

*The unpleasant truth is that for a vast number of people in our country corruption has become a livelihood - a routine feature of everyday life. People are resigned to being confronted with such crimes. It is easier to pay up than to make a fuss, let alone go the police or the courts. Those who take bribes feel no danger or regard the risks as negligible. This is not how things should be.*

The unpleasant reality is that this is how things will inevitably continue to be long after Medvedev has left office. But while the plague cannot be eradicated, it can be controlled and progressively confined. This is true, above all, for those symptoms that affect the business climate and hence the potential for the economy to grow and for investors to secure attractive returns.

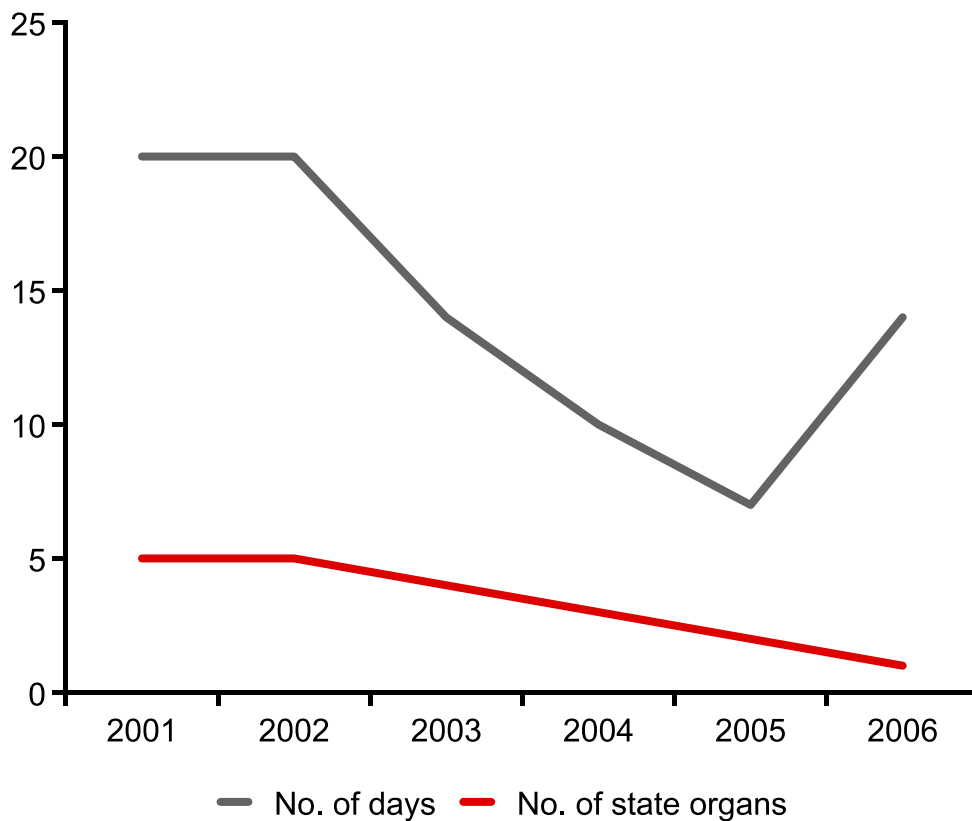
We predict that against the background of incipient recovery from the present economic shock and the labour market shake-out associated with this shock, Medvedev's campaign against the state mafia and civil service reform drive will contribute to a faster rate of small business creation. If so, the beneficiaries will include all sectors exposed to domestic consumer demand.

## Assumptions and Evidence

### The pattern of reform countered by predatory officials

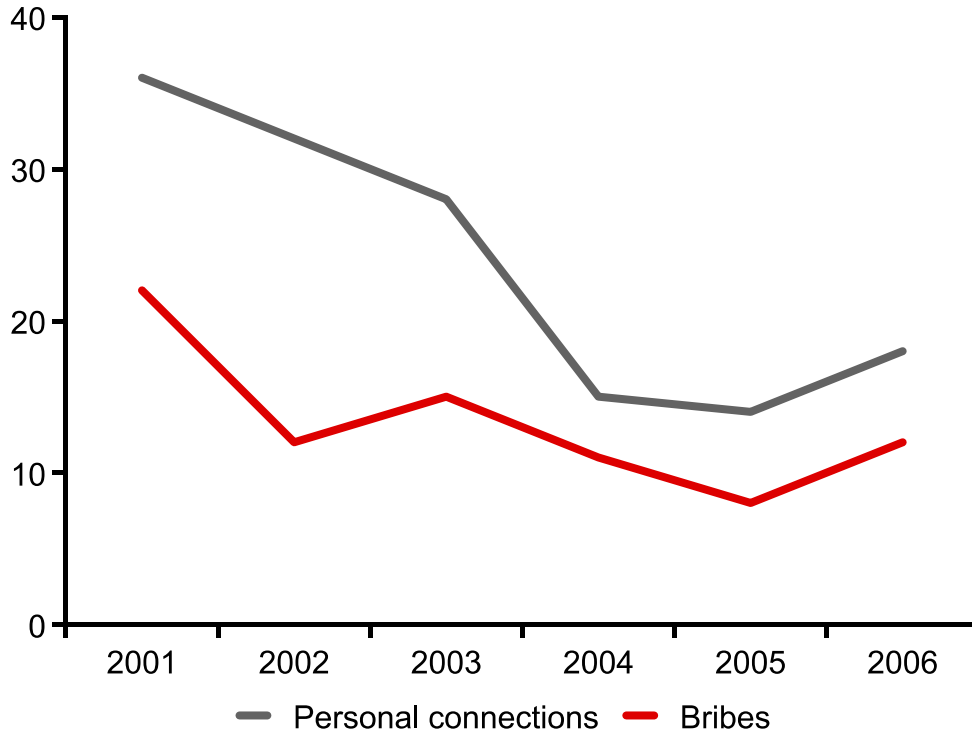
The following charts illustrate the pattern of reform countered by predatory officials that is revealed in the CEFIR monitoring study of the implementation of Putin-era laws designed to rein in the state mafia. It is on this basis that we argue that the Medvedev administration's return to the charge has the potential to achieve tangible results.

#### The amount of time and number of visits to state agencies required to register a business



Source: CEFIR.

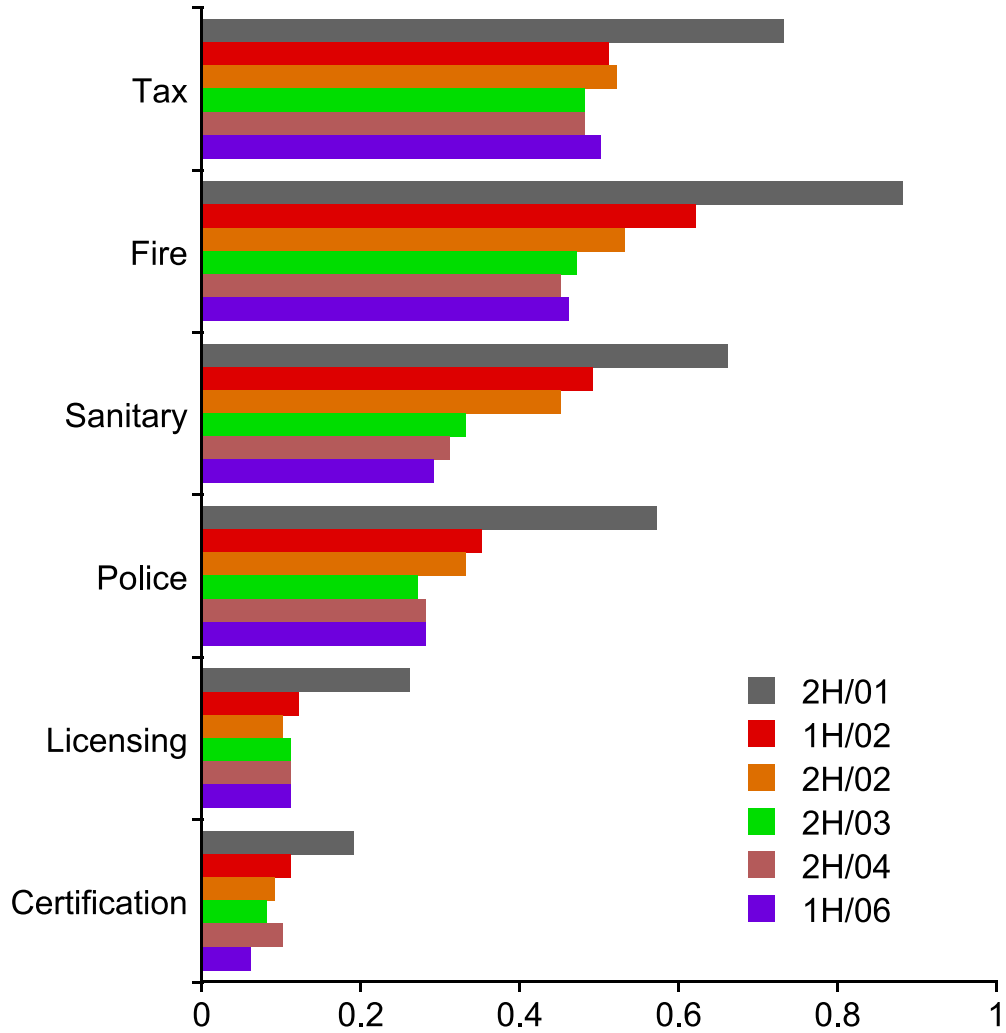
### The use of personal connections and bribes to register\*



\* Percentage of companies registering for the first time, without the use of intermediaries.

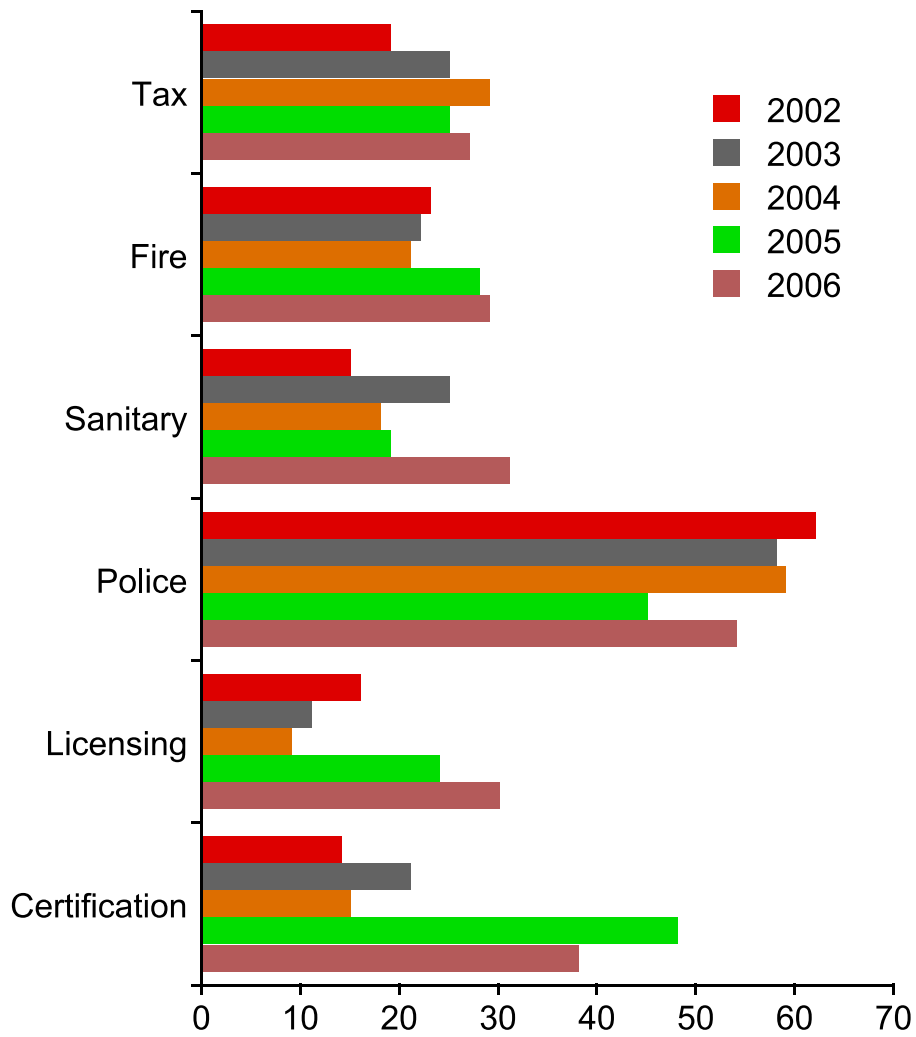
Source: CEFIR.

The average number of inspections by various agencies at any one firm over a six-month period (number of days)



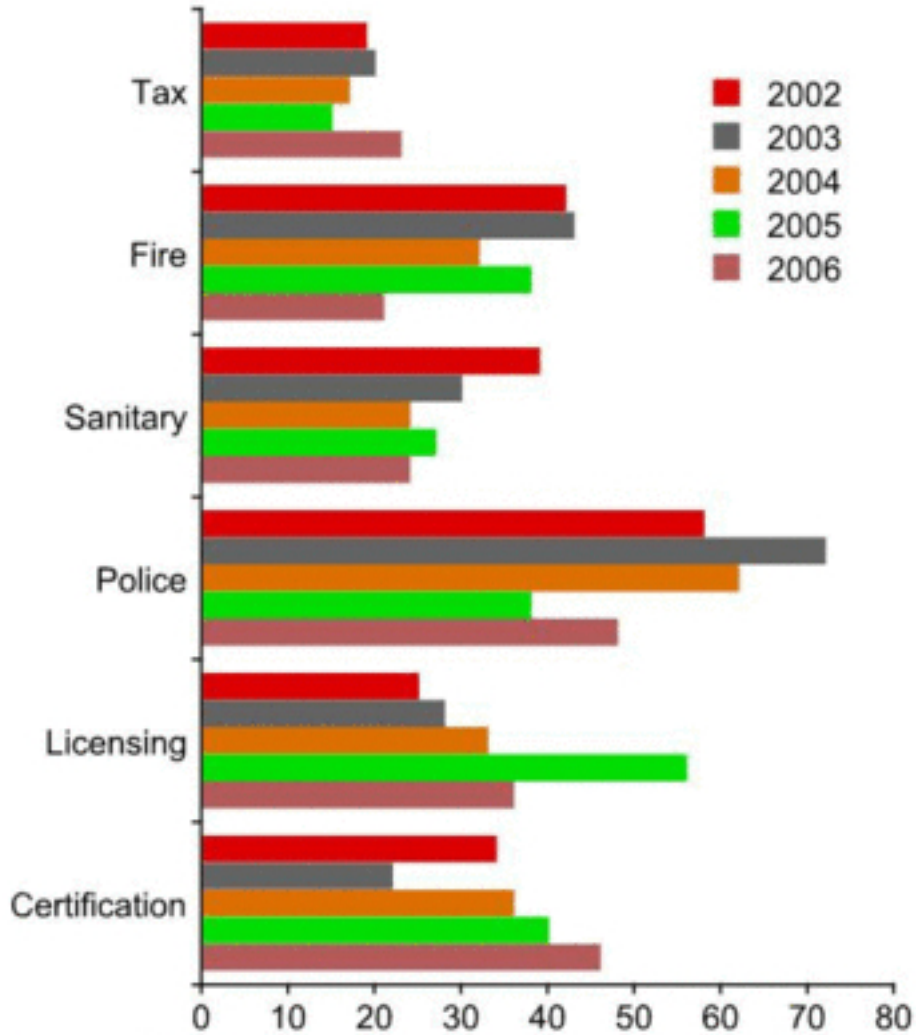
Source: CEFIR.

The share of unscheduled inspections in the total number of inspections (per cent)



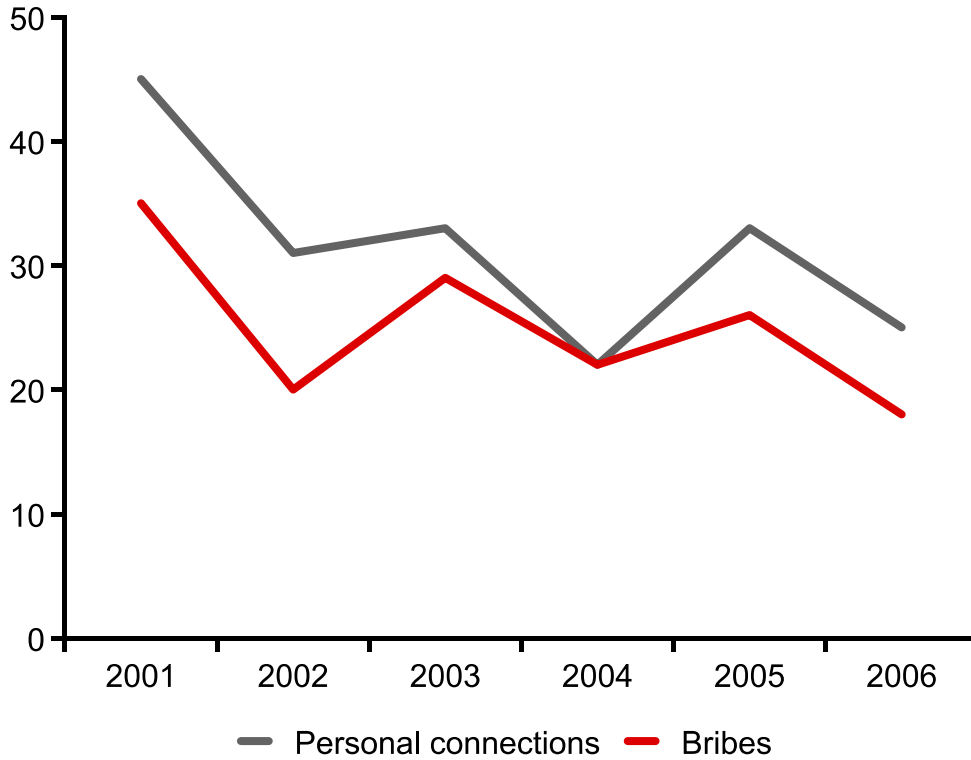
Source: CEFIR.

**The share of illegal fines (those not based on the official scale) in the total number of fines handed out to companies during inspections (per cent)**



Source: CEFIR.

### The use of personal connections and bribes to obtain licences\*



\* Percentage of companies applying for licences and permits.

Source: CEFIR.

## Contact us

If you would like to discuss any of the points made in this note, or ask further questions, please feel free to contact the authors:

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