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**Change, continuity and power in the Russian political economy in comparative BRICs perspective**

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**Chapter 3:**  
**Trapped in informality:**  
**The big role of small firms in Russia's statist-patrimonial**  
**capitalism<sup>22</sup>**

**Abstract**

Manifestations of patrimonialism such as corruption and state predation on business are widespread in many emerging economies. This paper presents the case of Russian political economy, dubbed 'statist-patrimonial capitalism', which is marked by state threats to private property rights through bureaucratic extortion or legal harassment. How can we explain the resilience of Russia's statist-patrimonial capitalism? Predominant accounts focus on the lack of institutional constraints on state predation. The paper offers a different perspective by exploring the often-overlooked contribution of small- and medium-sized enterprises (SMEs). First, statistical data show a steady rise of SMEs in the 2000s despite increasing state predation, suggesting that SMEs are not simply subjugated by the state. Second, in-depth interviews with Russian entrepreneurs reveal that business contributes to the maintenance of the statist-patrimonial system through the mechanism of the 'informality trap': firms that choose the informal strategy have difficulties to return to the legal sphere and get stuck in informality. The drivers of informality include firm-specific characteristics, institutional factors and socio-cultural factors dubbed 'normality'. The mechanism of the 'informality trap' highlights the agency of firms in corrupt polities and may be applicable to other emerging economies.

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<sup>22</sup> This chapter is published in *New Political Economy* (Vasileva 2017).

## ***Introduction***

Overcoming corruption, tackling the shadow economy and limiting government predation on business are widely regarded as crucial for successful socio-economic development (Hickey 2012; Auberbach and Azariadis 2015). Many emerging economies face these challenges, Russia as much or more than most. Its current model of political economy emerged in the early 2000s and was consolidated during president Putin's rule. The model is marked by the pronounced involvement of the state in the economy, often referred to as 'state capitalism' (Lane 2008; Sakwa 2008; Hanson 2007), as well as various entrenched manifestations of patrimonialism such as clientelism, rent-seeking and corruption (Becker 2014; Robinson 2011; Easter 2008, King 2007)<sup>23</sup>. One of its key manifestations is state-sponsored violent pressure on business, such as extortion, legal harassment and even illicit asset-grabbing (Gans-Morse 2012; Rochlitz 2013; Yakovlev et al 2014; Kosals and Dubova 2012). I dub this model 'statist-patrimonial capitalism'.

Such a pattern presents political economy scholars and policymakers with an important question: How does the statist-patrimonial system maintain and reproduce itself, and what role does business play? The various answers to this question in existing scholarship tend to emphasise the view that firms, in particular small and medium-sized enterprises (SME), are victims of state predation. One prominent argument explains the maintenance of Russia's statist-patrimonial political economy as reflecting the lack of effective institutional constraints on state predation (Markus 2012; Kluge 2017; cf. North and Weingast 1989). Thereby the state is viewed either as a strong authoritarian actor that subjugates business (Gans-Morse 2012; Paneyakh 2014), or as a weak institution that falls prey to corrupt officials who harass firms (Mendras 2012; Petrov 2011a; McFaul and Stoner-Weiss 2008). In this context SMEs<sup>24</sup> are commonly assumed to be suffering and squeezed by the state and its cronies in big business.

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<sup>23</sup> Other attempts to characterise the Russian type of political economy were produced, for example kleptocracy (Dawisha 2014) or crony capitalism (Sharafutdinova 2010).

<sup>24</sup> I use 'small firms' and 'SMEs' interchangeably.

Another strand of research focuses on business strategies by firms, small or large, that actively resist state pressure. Studies examine formal tactics to protect property rights such as the use of courts or mobilisation of stakeholders (Markus 2012; Aitchison 2014; Gans-Morse 2012). Here, the expectation is that small firms ought to include at least some that seek such formal institutional resistance. This intuition emphasises formal defence strategies and downplays any informal strategies that often might prevail among firms in interactions with state agents (Yakovlev et al. 2014: 188). Informal business strategies are discarded as not deserving further investigation, perhaps reflecting a liberal bias and teleological perspective of studies of Russian political economy (Hedlund 2008), or the practical difficulties associated with the study of informality (Ledeneva 2013: 150). In this view, in any event, SMEs are thought to be important in Russia's political economy as potentially, but in fact weakly, resisting the development of statist-patrimonial capitalism.

This paper takes issue with these views of the role of SMEs in the development in Russian political economy. Acknowledging the important contribution of the state to that development, I argue that the recent consolidation of Russia's statist and patrimonial capitalist form was not purely a statist grab, and is more nuanced than a story of 'business subjugation'. In particular, I demonstrate that the bulk of economic actors, actors that are mainly SMEs, are implicated in the current politico-economic system and represent one of its pillars. At the same time, acknowledging the importance of formal corporate defence strategies, I argue that the much more widespread strategy involves informal arrangements, and that informal activities by SMEs contribute to the maintenance of the statist-patrimonial political economy.

My central hypothesis is that SMEs are one important pillar of the Russian statist-patrimonial politico-economic order. SMEs contribute to the maintenance of this order via the mechanism of the 'informality trap'. At the core of this mechanism is a vicious circle of informality: if a firm adopts an informal strategy (e.g. evades taxes or pays bribes), officials can use these illicit practices as a pretext for prosecution; to defend itself, the firm cannot readily deploy formal means (e.g. court) because of the committed violation and thus depends on informal arrangements with the officials. Stuck in the informality trap, SMEs inadvertently express

tolerance of the politico-economic system, profit from it, provide it with legitimacy and thus help sustain it.

To show how this might be so, I develop two sub-claims that clarify the vibrant coexistence of SMEs and Russian statist-patrimonial system, and the ways that such coexistence might be more than coincidence but in fact reflect SME contribution to that system: (1) Using descriptive statistics of the sector, I show that SMEs have not been suppressed but in fact have been rapidly developing despite state threats to property rights; (2) Focusing on informal business strategies of SMEs on the basis of in-depth interviews I can trace an active role of SMEs in the maintenance of the Russian system of economic governance and development.

A challenge to this argument might be that the statist-patrimonial political economy and informal strategies of firms may be causally unlinked. The system may maintain itself thanks to natural resource extraction (Rutland 2008) and rent-distribution chains (Gaddy and Ickes 2013), while SMEs' informal activity, tolerated by the system, may be due to underdevelopment, that is, poor legal institutions or the lack of resources. Indeed, a large body of literature in development economics shows that corruption may be even beneficial in the early stages of development, helping business to cope with institutional uncertainty and 'greasing the wheels' of economic development (Easterly 2006). Contrary to this interpretation, I will argue that SMEs' informal strategies may be not only a response to underdeveloped institutions or objective state pressure such as extortion, but also a matter of conscious choice reflecting the predominant societal 'normality of informality'. Rather than merely echoing corrupt patterns in the higher echelons of the political economy (see, for example, Barsukova and Radaev 2012; Ledeneva 2013), SMEs' behaviour has a causal impact on the statist-patrimonial system of its own.

The empirical contribution of the study lies in the account of the distinct role of small firms in the functioning and maintenance of Russia's statist-patrimonial political economy through the analysis of statistical data and evidence from in-depth interviews. I show how, far from being victims, small firms are complicit in the functioning of the statist-patrimonial system and actively reproduce it. I also account for the often neglected fact that different behaviour strategies (formal versus informal) may be

not equally available to firms. By examining a set of factors that make business opt for a particular strategy I explain why and under what circumstances firms may fall into the informality trap. In theoretical terms, the notion of informality trap offers an instrument for understanding the working and sustenance of Russia's current economic form and may help shed new light on broader questions about the resilience of highly patrimonial political economies (Becker 2014).

The empirical basis of the study is historic statistical data on SMEs from the Russian statistical service Rosstat, secondary literature and anecdotal evidence from semi-structured in-depth interviews conducted in spring 2014. Given the character of the data and the interpretation involved, it should be noted that no hard evidence can be provided for the working of the informality trap and the causal effect on the maintenance of Russia's statist-patrimonial capitalism that I describe. But the evidence is suggestive in its support for the hypothesised informality trap. My argument does not attempt an all-encompassing explanation of stability of Russia's current economic form. But it draws attention to an important factor that has not received sufficient attention in the discussion.

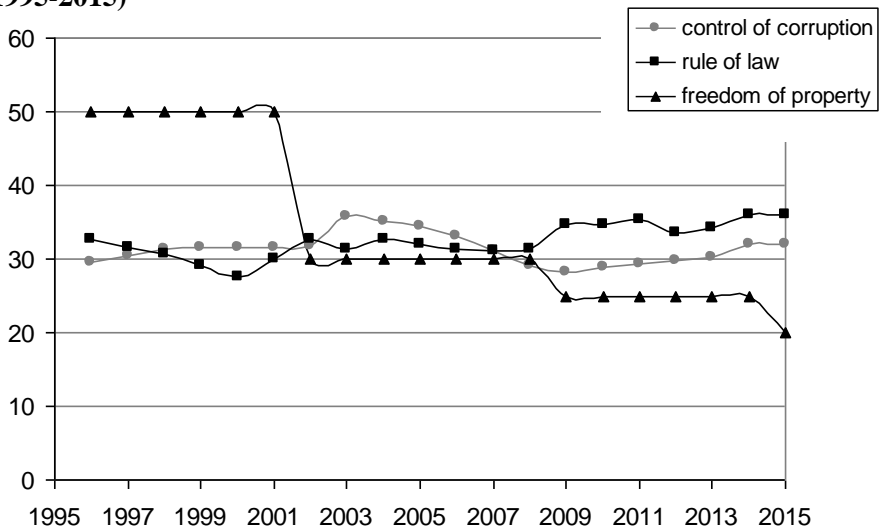
The remainder of the paper is structured as follows. Section II shows SME growth despite state threats to property rights by reviewing statistical trends. Section III details firms' contribution to the functioning of the statist-patrimonial system through the mechanism of informality trap, by providing a detailed analysis of firms' strategies based on data from the interviews. The concluding section IV reflects on the findings and suggests directions for further research.

### ***The dynamics of small firm development***

From examining Russia's business environment, it is evident that the indicators 'control of corruption', 'rule of law' and 'freedom of property' have done poorly in the past two decades (figure 5; cf. Becker 2014). *Freedom of property* has deteriorated, dropping from 50 to 20 points out of 100 since the 1990s, according to the Index of Economic Freedom (Heritage Foundation 2015). Private coercion (criminal protection rackets) that was rife in the 1990s has given way to state aggression such as extortion and legal harassment in the 2000s (Gans-Morse 2012). Regulatory officials and law enforcement agents have become notorious

state predators in Putin's Russia, using the judiciary and coercive state machinery for the attainment of their private goals. For instance, one quarter of firms surveyed by Gans-Morse in 2010 faced conflicts with the authorities regarding payments and fines, almost a fifth experienced extortion from tax agencies, 6% faced trumped-up charges and 8% came under a raiding attack (Gans-Morse 2012a: 6). A penalty like 'halting the operations up to 90 days' can be given for many, even minor, violations (for example, regarding ecological, sanitary or labour norms), and can make a small firm go bankrupt (interview with L2). This threat became imminent after the adoption of a new law in 2014, which allows not only judges but also law enforcement agents to impose this penalty. Moreover, law enforcement agents can threaten firms with criminal prosecution, often with the goal of extorting bribes or seizing lucrative assets (Volkov et al. 2010). The ban that prohibited pre-trial arrests of businessmen accused of economic offences along with other attempts to 'liberalise' the Criminal Code in 2010 did not have any significant effect on law enforcement practices. Overall, they did not help to reduce violent pressure on business (Yakovlev et al. 2014: 178).

**Figure 5: Dynamics of corruption, rule of law and property rights (1995-2015)**



Source: World Bank, World Governance Indicators; Heritage Foundation, Index of Economic Freedom. Note: all indicators are converted to a scale from 0 (lowest) to 100 (highest).

Similarly, a continually low level of *control of corruption*, though not a direct indicator of state predation, points to an adverse business environment. According to the World Bank, after improving in the early 2000s the situation has worsened again since 2003. Despite another very modest improvement since 2010, control of corruption has remained very low, just 32 points out of 100 (World Bank 2015). The share of firms who identified corruption as one of the top constraints to doing business in Russia more than doubled between 2002 and 2012, reaching 33% (BEEPS 2012). Similarly, a survey by Frye and colleagues shows that among manufacturing firms the perception that bribery is a major problem also increased between 2000 and 2007 (Frye et al. 2009: 41).

The *rule of law* improved slightly in the 2000s, but overall it remains at a very low level, according to the World Governance Indicators (36 out of 100 points in 2015). Such weak rule of law is expressed in biased judiciary and bureaucratic discretion in law enforcement. Both factors facilitate the predatory behaviour of state-backed wielders of violence. The judicial system is closely connected to and often sides with law enforcement bodies like the police, or investigation and prosecution authorities. This in turn results in the bias towards prosecution (Yakovlev et al. 2014: 175). Additionally, the internal performance standards and promotion incentives in the police (the so-called 'stick system', Paneyakh 2014) and rent-seeking of law enforcement officials has intensified the criminal prosecution of businesses (Nazrullaeva et al. 2013). The fact that economic crimes require a proactive investigation by Russian legal authorities provides its officials with significant discretion to probe and persecute a wide range of firms (Gans-Morse 2012: 285).

The World Bank's Ease of Doing Business ranking, which focuses on time and costs needed related to starting a business, registering property, getting electricity, construction permits and the like, shows an improvement in Russia's business environment: from the 123rd rank out of 183 economies in 2011 to the 36th out of 189 in 2016 (in 2017, it slid to the 40th place) (World Bank n/a). However, since the ranking captures formal requirements and does not necessarily reflect the reality on the ground - such as corruption and bureaucratic discretion - we need to take the results with a grain of salt.



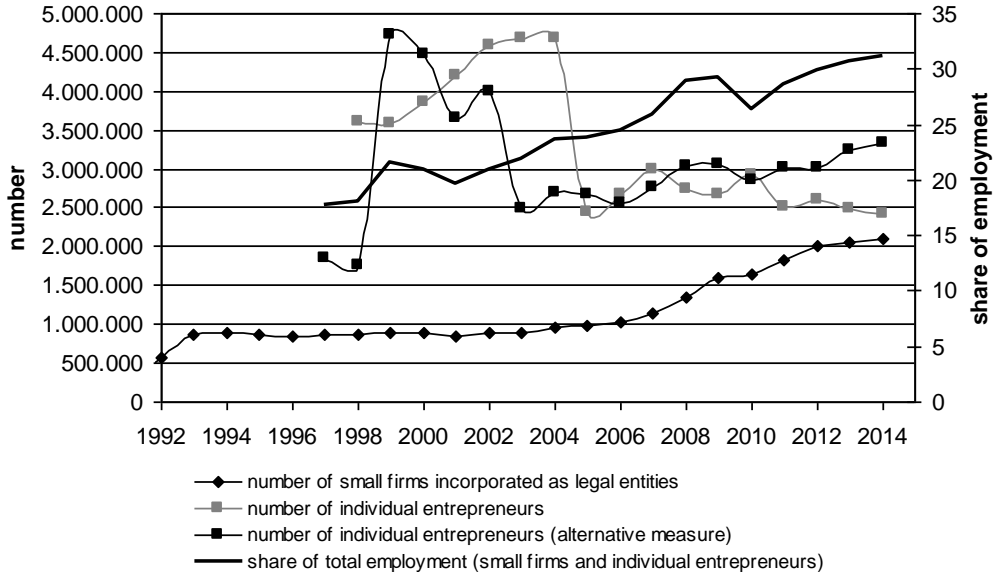
Despite the adverse business environment and predatory pressure from rent-seeking bureaucrats, SMEs have been growing as a share of the economy.<sup>25</sup> Overall, the Russian SME sector is comparatively small, contributing roughly 20% of GDP as opposed to 50-60% in advanced industrialised economies. Big firms traditionally loom large in the Russian economy (Tompson 2012: 259). Only 2% of people consider starting their own business, compared with 26% in countries with comparable income (OECD 2014: 64). However, SMEs have been rapidly increasing since the 1990s, both in absolute numbers and in their share of total employment (figure 6). SMEs that are incorporated as legal entities<sup>26</sup> have increased almost tenfold in the last two decades, reaching more than 2 million in 2014. The rise was especially steep in the 2000s up until the 2008/2009 economic crisis. After 2009 SME growth slowed but recovered from 2011 onward. It should be noted that in the 1990s many firms were operating in the shadows and thus were not captured in official statistics. However, this is likely offset by the similarly high number of registered but idle firms, as well as shell companies (Polishchuk 2001). As a percent of the total number of firms SMEs also increased their share in the last decade and a half, from 92% in 1996 to 95.5% in 2014<sup>27</sup>.

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<sup>25</sup> In this statistical overview of SMEs I include firms (legal entities) and sole proprietors (individual entrepreneurs).

<sup>26</sup> I include legal entities with up to 100 workers, following the threshold used by the Russian statistical service (the standard international threshold is 50 workers). Although before 2008 Rosstat used a different assessment (various thresholds depending on the economic sector), we can assume the general comparability of the data. Firms with 101–250 employees are not included because data on them were not collected before 2008.

<sup>27</sup> Own calculations on the basis of Rosstat data.

**Figure 6: Development of Russian SMEs (1992-2014)**

Source: Rosstat, own calculations.

According to official Rosstat figures, the number of people employed by small firms incorporated as legal entities has almost doubled between 1997 and 2014, accounting for a 23% share of employment. My own calculations<sup>28</sup> yield a more modest increase from 10% to 15%. One reason for this deviation may be that the available indicator for the number of employees in small firms - 'average listed quantity of workers' - does not accurately capture the actual number of workers because the statistical assessment includes estimates. However, we can expect that employment figures are under- rather than overestimated. As numerous examples from my interviews suggest, many firms use various bookkeeping 'tricks' or prefer to hire some of the workers unofficially in order to avoid taxes or qualify for government support programmes and

<sup>28</sup> The total number of people working in small companies divided by the number of total employment in Russia. Both indicators are available on the website of Rosstat.

simplified tax schemes as 'small businesses' (that have 100 employees or fewer). In any case, even if we stick to the more modest estimate obtained through my own calculations, we can see impressive growth in the share of SME employment.

The development of individual entrepreneurs has been less even. Official figures show abrupt rises and falls in the number of individual entrepreneurs during the late 1990s and early 2000s. One reason for this may be that the sector fluctuates strongly. Thousands of sole proprietors open and close down each year, and the average 'life span' of such a business is relatively short (Rosstat 2012). For instance, in 2013, after the state doubled the social tax, almost half of individual entrepreneurs closed down in the following year (this drop is not yet reflected in the available statistics). Another reason for the uneven development of individual entrepreneurs may be due to the inconsistent measurement in annual SME surveys.<sup>29</sup> Most likely this accounts for the 'jump' in the data between 2004 and 2005 (grey line in figure 6). To address these caveats, I included an alternative form of measurement based on people's self-reporting in general employment surveys. According to this measurement individual entrepreneurship experienced a steady rise in the past decade - from 2.5 million in 2003 to 3.3 million in 2014. However, prior to that decade the numbers show very uneven development: the very large increase in 1999 (from 1.8 to 4.7 million) may be due to the default of 1998 and the subsequent economic crisis that left many Russians unemployed and may have prompted them to open their own business. Subsequent drops in individual entrepreneurs' numbers until 2003 may be due to the stabilisation of the economic situation.

Individual entrepreneurs, who in Russia can hire employees, more than doubled their share of employment, from 7% in 1997 to 16% in 2014. Here the official Rosstat figures are roughly in line with my own calculations. Bearing in mind the caveats regarding how the number of people working in this sector are counted, we can conclude that

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<sup>29</sup> While until 2004 Rosstat counted individual entrepreneurs on the basis of registration with the tax authorities, after 2005 it only accounted for those that were 'included in the unified state registry'. Since 2008 Rosstat switched to an even more opaque measure of the number of 'factually operating' individual entrepreneurs.

throughout the last two decades individual entrepreneurs comprised a similar share of total employment as the small legal entities did. The combined share of employment from legal entities and individual entrepreneurs grew from around 18% to over 31% (steady black line in figure 6). On balance, half of the people employed in the Russian SME sector work for the smallest businesses, that is for individual entrepreneurs. Also, the majority of those who are employed at small legal entities work in the smallest ones, known as microfirms. Like in the West, around 80% of the Russian small firms have less than 15 employees. A large proportion of SME employees work in retail; 38% of the legal entities and 52% of individual entrepreneurs engage in retail and trade (Rosstat 2012: 56f).

My analysis of statistical data corrects two impressions that may appear in predominant accounts of Russia's statist-patrimonial capitalism. First, SMEs are not crowded out by big business, even though big firms account for the larger part of the economy in terms of employment and GDP. In fact, the share of big firms has been falling, whereas that of small firms has been on the rise. Second, and somewhat counter-intuitively, SMEs seem to represent a dynamic and developing sector during a period marked by the rise and intensification of Russian state predation. This trend accommodates my central claim that the Russian SMEs are a pillar of the Russian political-economic system. They have managed to adapt to it and perhaps even to contribute actively to its maintenance. To be sure, various factors may be responsible for the growth of small firms despite state predation.<sup>30</sup> However, for the purposes of this paper I will not explore this issue. Rather, I will analyse how small firms' strategies may have contributed to the maintenance of Russia's statist-patrimonial capitalism through the mechanism of the informality trap.

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<sup>30</sup> Among the conceivable factors are: 1) 'a dead cat bounce': inevitable rise of SME numbers from a very low level after the collapse of communism; 2) 'dualism': some activities are not profitable for big business and are inherently relegated to SMEs. I owe these points to Andrew Schrank.

### ***Informality trap***

To make sense of the thinking and decisions that might plausibly underlie the trends in persistence and, indeed, growth captured by the statistics presented above, I conducted wide-ranging interviews with SME owners and managers. My interviews were with 23 small and medium-sized entrepreneurs, three business association executives, two business lawyers, two journalists and four academic experts (see detailed table in the annex). Corruption and informal behaviour are known to be sensitive topics, not readily amenable to social inquiry. As has been widely acknowledged, obtaining reliable data on state-business interaction in a corrupt environment is inherently difficult and runs the risk of a selection bias. To address this issue, I selected businesses capturing a sectoral variety among the Russian SMEs and chose my respondents as independently from each other as possible (see annex). Sometimes I relied on personal connections and recommendations to establish trust needed for a frank conversation about experience in dealing with the authorities in a corrupt environment (Ledeneva 2013; Lonkila 2011).

Most of the respondents were based in Moscow, with the exception of four entrepreneurs with companies in St Petersburg, Tver Oblast and Moscow Oblast. While this sample does not capture the geographical variety of Russian small businesses, and in general any results obtained through non-random sampling cannot be claimed as representative of the entire population of companies, there are good reasons to assume that small firms behave similarly across Russia. Regional specificities notwithstanding, Russian SMEs face similar environments and constraints: threats to property rights such as legal harassment, bureaucratic extortion or illicit asset-grabbing occur in all regions without significant variation, as Markus (2015) has shown. Therefore it is possible to draw generalisable conclusions from my interviews (cf. Vinogradova 2006).

Remarkably, my respondents talked to me relatively openly about their informal (and often corrupt) activities, however often misrecognising the latter and not calling a spade a spade (Ledeneva 2006). This may be due to the 'interviewer effect' of me being a young female native speaker, while my respondents were mostly men in their forties to sixties. At the same time, I came to conclude that this remarkable openness may in part

reflect the predominant 'normality of informality' - an issue that I address at length in the following part.

These interviews revealed, in any event, a clear pattern in the strategies and thinking among SME representatives. As elsewhere in the world, in Russia there are two fundamental business strategies - the formal and the informal. The formal business strategy (commonly referred to as 'white business') entails compliance with legislation and formal mechanisms to solve conflicts with the authorities, for example through courts (Gans-Morse 2012) or stakeholder mobilisation (Markus 2012, Yakovlev et al. 2014). However, in a corrupt environment the formal strategy does not always preclude government predation: in some cases clean bookkeeping may be even an invitation to trouble (Markus 2012: 256). Conversely, the informal business strategy, dubbed 'grey business', entails shadow practices such as tax evasion. 'Grey' firms typically solve problems with the authorities by using bribes or personal networks of 'useful acquaintances', based on mutual trust and a sense of obligation and reciprocity (but not necessarily bribes) (cf. Ledeneva 2006).

Even though various shadow business practices are widespread in Russia (e.g., Ledeneva 2006), doing 'white business' is far from impossible. Nine of my 23 business respondents claimed that their firms were 'white' (I believe that at least four of them were indeed in legal compliance), while eleven respondents admitted doing 'grey business'. The remaining three companies can be assumed to be engaged in some informal practices, too (see annex). There are good reasons to believe that this distribution roughly captures the occurrence of the two business strategies among Russian SMEs, but no hard data exists.

In practice, the formal and informal business strategies are mutually exclusive and cannot be easily switched. Firms conducting business in the formal fashion have little leeway to deploy informal practices such as bribery. But if they do, a return back to formality proves to be difficult because firms that behave informally may get trapped in informality. The mechanism of the informality trap is a vicious circle. Having violated regulations, evaded taxes or paid bribes, firms can be 'grabbed by the scruff of the neck' (interview with B15) since exposure of illicit conduct provides the authorities with a ground for bringing formal charges against companies (Yakovlev et al. 2014: 177, 189). At the same time, because of

legal noncompliance firms cannot easily defend themselves in a formal fashion, for instance in court. This makes firms opt for informal ways of defending their rights and solving conflicts with the authorities, for example through bribes or personal networks. As a result, firms face potential sanctions yet again (Ledeneva (2013) refers to this as 'suspended punishment'). Trapped in informality, through their behaviour firms inadvertently contribute to the functioning of the statist-patrimonial capitalism marked by insecure property rights.

Why and under which circumstances do firms fall into the informality trap? Acknowledging that the pervasiveness of informal practices in Russian business has numerous and complex reasons, I focus on three broad factors driving firms' informal strategy: a) institutional characteristics; b) firms' characteristics; c) socio-cultural characteristics dubbed 'normality'.

### **Institutional characteristics**

The first group of factors driving the informal strategy pertains to institutional characteristics. Institutions are deemed to shape and constrain the behaviour of actors, for instance by imposing transaction costs. Thereby the informal business strategy may be viewed as a response to institutional inefficiencies (Johnson et al. 2000). In the Russian case, flaws of the legal environment and law enforcement often make small firms behave informally (that is, commit violations) - both consciously and inadvertently. Thereby they seriously constrain firms' agency. In particular, three institutional characteristics appear to matter: overregulation; bureaucratic discretion in law enforcement; and bureaucratic extortion.

First, the overregulation of business activity is a serious obstacle for Russian SMEs. A 2009 survey of over 2,000 small Russian firms in 20 regions showed that the regulatory burden imposed by inspections, licensing and registration had remained largely unchanged since the mid-2000s (Bessonova et al. 2010). Moreover, the complexity and partial ambiguity of the rules makes breaches inevitable in some cases. For instance, a Moscow kiosk operator complains about the government-sponsored auctions for retail space that make it almost impossible to acquire appropriate space:

'[The state] creates a field in which it is impossible to do everything in accordance with the law. For example, 7 sq.m were auctioned for fish. Not even a fridge would fit in that. Or a pharmacy - 10 sq.m. According to the sanitary standards you need to have provision for sewage there. ... He [the official from sanitary agency] comes and says, "Why don't you have a water supply?" Non-compliance. They can close you down'. (interview with B19).

Other regulations are cumbersome or challenge the common sense, such as the rigid regulations on fire safety or sanitation. For instance, it is difficult to receive approval from the fire authorities for an exhibition booth at a trade fair without a bribe, unless you use unreasonably expensive materials deemed fireproof by the authorities (interview with B3).

The second institutional driver of informality is bureaucratic discretion in law enforcement, which is a predicament for many small companies. It may take the form of blatant legal harassment, like I unexpectedly experienced during one of my interviews, scheduled in a Moscow restaurant. The entrepreneur, whom I was going to interview, came with a 'friend', who turned out to be an assistant of a Duma (Parliament) deputy. Dissatisfied with the food and the service, the assistant brandished the Duma ID and threatened to call on the city authorities to close down the restaurant (interview with B1).

Bureaucratic discretion also comes to the fore in situations when officials strictly follow the letter of the law, but violate its spirit. For example, one entrepreneur illustrates the absurdity of the broad interpretation of the criminal law by rent-seeking authorities:

'The Criminal Code retains the spirit of Soviet-era prohibition against private enterprise. ... In particular, profit is often interpreted as the extraction of selfish interest. ... [The entrepreneur] sold for 100 roubles instead of 90, so the 10 roubles must be stolen. And where is the motive? Apart from the fact that the motive of every entrepreneur is to make profit?' (interview with B10)



Facing legal harassment, businesspeople are keen to avoid legal prosecution and try to resolve the conflict informally, making use of their networks or paying bribes. The reason for this is the financial and reputational damage caused to a company in case of legal prosecution. Business operations are usually suspended, bank accounts frozen and owners may even be imprisoned. Once in custody entrepreneurs have very limited possibilities to defend their rights (interview with L1).

Bureaucratic discretion in law enforcement may also entail more subtle pressure on firms. For example, the tax authorities are not keen on loss-making firms, which spoil the tax collection statistics, and make such firms forge financial statements. A furniture manufacturer from Kaluga recalls such a situation, echoing similar stories by a Moscow construction company (interview with B12) and a metal manufacturer from Tver Oblast (interview with B14). This example is particularly telling because it demonstrates how a 'white' firm is pushed to step outside the law without having committed any violation in the first place:

'If you report losses, the [tax authorities] summon you up and read you the riot act: "This is not allowed. You'd better not show [losses]; leave them out in the financial statements, we'll come to an agreement." On one hand, I want to be safe, to avoid further claims. But on the other hand I surrender and compromise. Later on I can be caught out by this compromise any time. You're on the hook.' (interview with B16).

The third institutional driver of the informal business strategy is bureaucratic extortion. Extortion by the tax authorities is among the most commonly-cited problem by Russian companies (Markus 2012: 256) and featured in many of my interviews. Sometimes extortion occurs in a crude fashion, when inspectors assert suspicions of tax evasion or are behind alleged 'tax collection plans' (most of my business respondents believed that such plans exist). The resulting fines and exorbitant back-tax claims can be lowered for a bribe, which some inspectors demand openly. Firms that evade taxes often prefer to pay a bribe and have cash that is off the books for that purpose. But even 'white' firms sometimes succumb to extortion and prefer to 'go with the tide' for pragmatic reasons, because a thorough inspection of the books, which may last

several weeks, is a waste of time for the business owner (interview with B3). However, by paying bribes 'white' entrepreneurs enter the grey zone, which makes them vulnerable to further extortion and legal harassment.

Bureaucratic extortion may be less apparent if it occurs through private companies affiliated with the authorities. These 'risk-free companies' often do not have local competitors and offer services that firms are legally required to purchase (interview with A3). As a result, the beneficiary of the company enjoys a stable revenue stream. A business association executive recalls an example:

'A person works as a chief of the fire inspectorate while his wife's firm provides services to entrepreneurs for risk assessment. This [risk assessment] is mandatory. ... So he [the chief of the fire inspectorate] demands from entrepreneurs that they order a risk assessment in this particular company. And he does so in a fairly blatant way.' (interview with A2)

In some regions the market appears to be divided informally into almost 'neo-feudal' zones of influence, under the purview of particular bureaucrats or affiliated companies (interview with E1). This indirect capture of parts of the economy by state-related actors limits competition and impedes market entry for new SMEs.

### **Firms' characteristics**

From the discussion of institutional constraints on small firms' behaviour it may appear as if firms had no agency at all - but in fact firms' characteristics may make a difference as they provide different room for manoeuvre. While small companies are mostly treated as a homogenous group, in practice they may be not equally likely to behave informally since they face different incentives and are not equally exposed to regulations (cf. Luo and Han 2009). Four firm characteristics appear to matter for the informal strategy: size, sector, 'outsourcing' capacity and ability to use courts.

First, size matters: larger and more profitable SMEs, such as in the pharmaceutical sector, or SMEs that have few competitors, such as producers of special products or popular brands, can 'afford' legal compliance. Such firms will have bookkeepers and lawyers, who are essential for navigating the numerous regulations governing businesses

and are better equipped to carry the cost of potential litigation (interview with L1). In contrast, smaller or less profitable SMEs tend to have fewer resources to pursue a formal strategy and are thus more likely to fall into the informality trap. Similarly, smaller or low-profile firms are ill-equipped to mobilise stakeholders or raise public awareness for defending property rights. Finally, few small firms can devote resources to lobbying or are members in business associations. The latter are deemed to provide at least some protection for their members given the pooling of resources, like Aitchison (2014) finds on the example of a successful lobbying effort of Russian SMEs to curb bureaucratic excess in the area of inspections.

Second, depending on the business sector firms are not equally exposed to administrative regulations and thus have more or less intensive contacts with state officials. The more contacts a company has with state agents, the more state threats to property it may face and, as a result, the more compelled it may feel to deploy informal practices. As a rule, more regulations, inspections or licensing requirements apply to firms in manufacturing, construction or food as opposed to firms in the service sector (retail, IT, consulting or publishing). The former firms tend to have more encounters with the officials and are thus more susceptible to corruption. Moreover, firms in the service sector are less vulnerable to state-backed asset-grabbing than firms in other sectors because 'the [main] asset are the people who work for us and the process that we built with our brains' (interview with B4). Some firms are bound to closely interact with the state and sometimes can hardly avoid informal practices. For instance, most construction companies that live off state contracts face pressure to pay kickbacks. The ability to conduct 'white business' is highly limited in these cases (interviews with B7, B12). However, a firm's negotiating position with the government contractor may vary depending on the kind of good or service provided: for instance, a Moscow-based company was able to avoid paying kickbacks as a sole supplier of a unique chemical vital for Gazprom - a state gas company infamous for corruption (interview with B10).

Third, firms differ in their ability to distance themselves from or outsource corruption-prone activities (cf. Polishchuk 2004; Shestoporov et al. 2008), which technically allows them to remain in the 'white' realm. For example, customs clearance or licensing procedures may be

delegated to professional consultants for a fee (interviews with B3, B9). Similarly, firms that choose to rent premises (widespread in the service or retail sector) rather than owning them (more typical in manufacturing) are not exposed to extortion by most agencies authorised to inspect businesses: usually the owner of the premises deals with them, including potential 'bribe expenses' in the rent (interviews with B5, B7). Finally, larger SMEs can afford to have opaque or sham subsidiaries that handle corrupt transactions (interview with B23).

Forth, the main formal mechanism for defending property rights - a court - in practice may be not equally available to all SMEs. On one hand, Russian firms seem increasingly willing to use courts to defend their property rights in disputes with state authorities. For instance, cases against the tax authorities and other government agencies increased almost fourfold between 2000 and 2008, reaching altogether about 90,000 cases a year or 20% of all cases initiated by firms. Win rates against the tax authorities hovered above 70% (Gans-Morse 2012: 274). On the other hand, suing the state may not be always feasible or desirable; instead, firms may opt for an informal defence of their rights. One reason is the retaliatory stance of some state agencies. For example, a medium-sized metal manufacturer from St. Petersburg, who won a lawsuit against the tax authorities, was later told by the very same authority that in the future his firm will be given 'very close attention' (interview with B18). Another businessman notes an unspoken practice that 'if a firm starts suing them [the tax authority], the bias of check-ups increases' (interview with B17). No matter whether a firm is 'white' or 'grey', the retaliatory stance of the inspection authorities may provoke further conflicts, which in turn may encourage or push firms to find informal solutions.

Furthermore, firms may prefer not to resolve disputes with the authorities in court for the sake of 'not spoiling relations'. This applies particularly to the kickback-ridden public procurement. A contractor may become hostage to a corrupt system and 'will not even think of fighting [formally]' (interview with B10). For example, entrepreneurs may prefer not to sue the state client even if it seriously delays or suspends payment because this may be counterproductive for future cooperation. An entrepreneur from St. Petersburg notes:

'The blackmailing is simple: "If you want to work with us [the state client], you will have to wait. If you do not want to work - feel free to sue us. For sure we will pay you. But in this case we will also put you in an informal black list".'  
(interview with B18)

Similarly, when local administrations demand 'voluntary' contributions from entrepreneurs to the municipal budget or the financing of pet projects, entrepreneurs are wary to complain 'since local authorities can make his life unsavoury.' (interview with A2).

On balance, some Russian SMEs are more likely to embark on an informal business strategy than others depending on certain firm-specific characteristics. Smaller and less resourceful firms, firms in manufacturing as well as those that engage in public procurement face some incentives to deploy informal practices. They often objectively have little room for manoeuvre for doing 'white business'. At the same time they may also face subjective incentives to 'hide' or stay 'below the radar screen' of the authorities, for instance for evading taxes, as discussed in the following section. In this context it is important to bear in mind that informal behaviour is not only a matter of pure necessity or objective constraints but may also be a matter of expedient choice, even for the smallest firms. This partly explains why some of the firms with similar characteristics, for instance small companies in the service sector, which make up the majority of my sample, choose different business strategies. In contrast, larger and more resourceful firms, as well as firms in the service sector, have more room for manoeuvre to avoid informal practices and be in legal compliance. At the same time those very firms also have more resources to afford evasion schemes and to 'outsource' corrupt activities. Here we see again that informal behaviour is determined not only by objective firms' characteristics but is also conditional upon rather subjective expedient choices (within existing constraints) reflecting the predominant societal normality, like we will discuss below. Even though it is not always possible to detect uniform behaviour patterns across similar firms, the focus on firms' characteristics does indicate which strategy the company is more likely to pursue. In any case, those firms that deploy informal practices are automatically in legal non-compliance and may fall into the vicious circle of the informality trap.

### Normality

The above examples amply illustrate that Russian firms may behave informally reflecting certain incentives tied to firms' characteristics or as a result of institutional pressures. However, often firms resort to shadow practices consciously (if not exactly voluntarily), reflecting widespread popular perceptions of normal and appropriate behaviour (Thompson et al. 1990), and thus responding to rather subjective incentives. I dub these taken-for-granted perceptions 'normality'.

#### *'Everybody does it'*

One aspect of normality concerns the prevalent notion that the whole business community allegedly engages in illicit practices. A businessman from St Petersburg pointedly expresses this view: 'In our country it is simply impossible to do business fair and square. ... [Illicit] schemes always exist.' (interview with B18). Indeed, the World Bank's World Business Environment Survey finds that in emerging economies with entrenched corruption, informal business practices may be considered a norm (Batra et al. 2003). Similarly, in post-communist states, individuals justify their own corrupt behaviour by the pervasiveness of corruption (Rose-Ackerman 2001: 438) according to the motto 'If others do it, so can I'. Another study of determinants of corruption in post-Soviet transition economies finds that widespread informal norms increase the likelihood of corrupt behaviour (Tonoyan et al. 2010). In this context Russian businesspeople tend to view informal practices as part and parcel of day-to-day business operations: 'This is the rule followed by the whole business community of the country.' (interview with B20). Legal compliance is considered an option rather than a norm (interview with B6). Moreover, cutting corners is viewed as a factor of competitiveness - if you do not join in, you lose out:

I do not want to be a tax violator, to be under the sword of Damocles. But what is going to happen in such a case? I immediately become uncompetitive, because this [shadow scheme] is the rule by which the whole market plays. You will not be able to compete price-wise. You will pay taxes several times larger than those that everybody else pays.' (interview with B20).

*'It is a pity to pay taxes'*

Another aspect of normality concerns the deeply embedded attitude towards the state as an oppressive and venal institution. Historically, the officialdom has been feared and despised by the Russians while the state has been perceived as working not for the society, but against it (Stoner 2012: 975). Law in Russia is traditionally associated with the power of the arbitrary state machine rather than any notion of justice; it is feared and circumvented rather than respected (Ledeneva 2006: 27).

In this context 'beating the system' is commonly perceived as morally acceptable. Back in Soviet times, stealing from the state was considered a normal response to state ownership of the means of production (Goldman 2003: 43). Pilfering, or abuse of the working position and the misuse of state-owned enterprise resources, was widespread and not considered illegitimate (Barsukova and Radaev 2012: 5). Against this backdrop, some small businessmen consider paying taxes a waste, a nuisance or even a donation to the corrupt bureaucrats: 'I am not sure that our taxes go where they are supposed to. It is even a pity to pay them.' (interview with B12). The notion of a state keen to fleece entrepreneurs propels a lax attitude to taxes: firms do not shy away from admitting paying only 'some taxes' (interview with B7), 'half of what we are supposed to' (interview with B9) or paying taxes 'according to our possibilities' (interview with B12).

*'Let's come to an arrangement'*

While the state as an anonymous machinery is utterly mistrusted and widely perceived as inefficient and corrupt, personal connections with state officials based on trust and reciprocity are cherished. Such connections 'for the sake of maintaining good relations for the future' (interview with B5) are regarded vital for the security of businesses and are used to prevent or solve problems.

Having established personal relations with bureaucrats, small businessmen expect not privileges but rather absence of obstacles. This practice goes back to the 1990s, when the Russian state was largely dysfunctional and the bureaucracy underpaid, so that citizens and entrepreneurs gave 'gifts' to state officials to perform even their basic duties. Today's custom of generously 'thanking' officials or doctors for

proper services or treatment reflects the same practice. As Vladimir Pastukhov puts it, 'it is not the violation of the law but its fulfilment that is paid for in Russia' (2002: 68). For instance, the owner of a small medical clinic offered a job to 'the son of the official who was inspecting my business ... in order to head off any artificially created problems' (interview with B6). Similarly, some manufacturing firms adopt voluntary 'social responsibility' in the form of support for local projects in order to establish 'good relations' with the authorities. For example, a plant owner from Tver Oblast admitted supporting two local colleges (interview with B14), while a factory owner from Moscow Oblast reported that he financed a canteen for local veterans, hoping to appease the authorities (interview with B22). This anecdotal evidence echoes Frye's (2006) finding that investing in public goods helped formerly state-owned firms privatised in the 1990s to prevent state threats to their property rights.

Informal connections with state agents can also help to solve problems. *Dogovoritsa*, or 'to come to an arrangement', is one of the most common verbs used by entrepreneurs to describe the resolution of conflicts with the state. Having high-placed 'friends' in the state administration is considered crucial for negotiating such informal arrangements (not all of which involve bribes, as I learned in the interviews). For example, several times during the interview the owner of a sausage kiosk chain instantaneously solved problems with local migration police who were harassing his foreign-looking employees by calling one of his patrons in the police department on his mobile phone (interview with B13).

On balance, many Russian entrepreneurs seem to regard personal connections and informal arrangements a better protection of property rights than formal channels. At the same time, informal arrangements undermine the rule of law because they foster the exclusiveness of the legal system. Rather than applying general rules, 'specific affair is solved as an exclusive matter in a special way' (Pastukhov 2002: 68). This is conducive to the informality trap.



*Doing business 'by acquaintance'*

Finally, normality concerns the - fairly cynical - perception of the most effective ways to do business. In matters of registration, licensing and business inspections informal deals appear to be a welcome shortcut in a cumbersome Russian regulatory jungle:

'It is much easier to *dogovoritsa* [come to an arrangement], than carry formal costs. ... It is just quicker, more mobile and easier to make money instead of waiting for all those permissions. It is easier to bribe than not to work for a month. ... Everything is in the grey zone of personal contacts, well-established relations. This accelerates the process and makes it cheaper.' (interview with B5)

Given that the noncompliance with some, sometimes even minor, requirements (many of them purely technical, for example, quality of water or intensity of light) may lead to serious sanctions, 'it is easier to *dogovoritsa* with him [inspector] than try to comply with all those minor regulations' (interview with L2), admits a lawyer specialising in conflicts with state organs. In general, paying taxes, obtaining licences or drawing up proper work contracts and invoices is sometimes viewed as unnecessary transaction costs rather than a *sine qua non* of a legal business operation. Some small companies consider doing business 'po znakomstvu', literally 'by acquaintance', more efficient. An owner of a small company providing legal services notes: 'We have a lot of clients who do not need any paperwork [invoice]. ... We work with five big regular customers. I know them personally.' (interview with B9). Similarly, an owner of a private kindergarten prefers not to bother with cumbersome licensing believing that the parents 'are our loyal clients that are satisfied with everything' and thus will not complain to the authorities (interview with B8). Doing business 'by acquaintance' firmly puts firms in the 'grey' realm and pushes them into the informality trap.

From the previous discussion two points appear noteworthy: First, SMEs' informal behaviour is not only a matter of institutional constraints but also of firms' given characteristics such as size and sector that to some extent determine the room for manoeuvre. Second, informal behaviour may be also driven by more subjective incentives that reflect the

dominant societal normality and may lead similar companies in the same environment to behave differently. Within given constraints, the informal choices that SMEs make in response to certain incentives often trap them in the vicious circle of informality and thus make them inadvertent contributors to Russia's statist-patrimonial political economy.

### ***Concluding remarks***

This paper examined one mechanism of the maintenance of Russian statist-patrimonial political economy from the perspective of an often overlooked player - small and medium-sized firms. Quantitative assessment of the evolution of Russian SMEs in Putin's Russia revealed that statist-patrimonial capitalism accommodated a living small enterprise sector: SMEs grew as a share of the economy in the course of the 2000s despite increasing state predation. Drawing on evidence from in-depth interviews, I concluded that this coexistence was more than coincidence. In fact it reflected SME involvement in the statist-patrimonial system and their contribution to its maintenance through the mechanism of the informality trap. Having embarked on an informal behaviour strategy in relations with the authorities, firms deviate from legal compliance and thus deprive themselves of most legal ways to secure their property. As a result, firms are bound to behave informally in further interactions with the authorities and get trapped in a vicious circle of informality. This circle reinforces itself and thereby gives sustenance to the particular mode of operation of Russian capitalism.

Three groups of causal factors were studied in order to examine why firms fall into the informality trap - institutional characteristics, firm characteristics, and socio-cultural characteristics. Thereby the study revealed that only part of the informal business activity could be attributed to institutional constraints such as cumbersome regulations, poor law enforcement or bureaucratic extortion. This finding is in line with the predominant assessment in the literature that attributes the maintenance of Russia's politico-economic system mainly to underdeveloped institutions and state predation. Much more tellingly, the study also revealed that firms in some cases embarked on an informal strategy as a matter of own choice, reflecting various aspects of deeply embedded social norms and routines dubbed 'normality'. In other words,

companies embarked on informal practices not responding to objective constraints or by necessity but reflecting their own expedient choices which were not inevitable as a condition for staying in business. The origins of the normality of corruption, of cheating the state as well as of personal relations with state agents could not be addressed in the study and present a challenging and intriguing avenue for further research.

The study further addressed a largely overlooked issue that in practice a particular business strategy is not equally available to all small firms. A formal business strategy may be more or less feasible depending on the specificity of business (such as size or sector), on the exposure to particular regulations and the ability to outsource corruption-prone activities. Many small firms lack the according characteristics and are compelled to behave informally.

To be sure, the present analysis highlights only one possible causal interpretation of how the statist-patrimonial system is sustained, namely the - albeit limited - agency of firms. A challenge to this interpretation concerns the relation between the agency of small firms and the institutional context in which they are situated: by behaving informally, firms could be merely reacting to the statist-patrimonial system and adapting to institutional contexts by which they are constrained. However, even if the informality trap is an effect of the pre-existing politico-economic order rather than its cause, this study has demonstrated that the informality trap is nevertheless functional to the maintenance of that order. In this context we should imagine the behaviour of SMEs as one link in the causal chain that has a recursive effect on the stability of Russia's statist-patrimonial capitalism.

The presented argument does not aspire to provide an all-encompassing explanation but rather represents one - so far largely overlooked - piece of the puzzle. A comprehensive answer to the question why a statist-patrimonial politico-economic form got entrenched in Russia requires a broader look that encompasses a number of factors on different levels of analysis. Among them is the failure of the rule of law, low public accountability of politics, short planning horizon and high uncertainty that imperil long-term investment and poor access of firms to finances, to name a few. Moreover, further research is required to analyse the role of

large companies and whether similar mechanisms like that of the informality trap apply to them.

In conceptual terms, the central notion of informality trap may have offered an instrument for understanding the working and sustenance of a highly patrimonial political-economic form, potentially useful for the analysis of other non-Western political economies (see, for example, Natrass' (2014) account of South African capitalism). Above all, the presented argument challenges the top-down perspective, which focuses on the role of the state and its rent-seeking servants, providing evidence for the contribution of the bottom-up forces of society. In theoretical terms, the study reminds us of the necessity to complement predominant institutional approaches to the study of emerging economies with approaches that consider socio-cultural factors (Staricco 2017). However, the study has been able to say little about the origins of the highly patrimonial political-economic system and the role that informality trap may have played in its creation. Has the small business sector helped shape the trajectory of Russian political economy through the way how it operates in it? The results of this research suggest a tentative 'yes': the evolution of Russian capitalism may have been conditioned not only by the interplay of post-communist political elites and the oligarchs, the citizenry being at the receiving end, but possibly also by the activity of the bulk of economic actors. Further research could provide insights into causal implications of the informality trap for the rise of the statist-patrimonial economic form. In this context, the present depiction of the substantial contribution of small firms to the functioning and reproduction of Russia's statist-patrimonial capitalism underscores the salience of such topics.