Informal Institutions in the Corporate Governance System in Russia

Abstract

The corporate governance system in Russia, having evolved through years, can be characterized by the following features: the dominant role of the concentrated ownership structure, corporate supervision relying on a combination of ownership function and company management, the significant role of the state as the owner, and the fairly marginal relevance of external market mechanisms. Those features result partly from particular legal solutions and partly from the unwritten, informal customs or patterns of behaviour of the so-called informal institutions.

The article’s main thrust is to analyse selected informal institutions which were considered the most significant from the Russian corporate governance system point of view. These are, among others: the tendency not to obey the rights of minority shareholders, informal relationships of enterprises with authorities of various levels, and corruption. The author assumes that informal institutions decide upon the specificity of the corporate governance system in Russia and its particular elements, and upon the efficient functioning of supervisory mechanisms.

Keywords: informal institutions, shareholder rights, state, corruption

JEL Classification: B52, K23, L22

1. Introduction

The economic transformation in Russia, apart from the fact that it resulted in establishing the main elements of a market economy, also enabled the creation and development of the corporate governance system. Having evolved over the years,
many specific features of the system have been shaped, such as: the dominant role of the concentrated ownership structure, the reliance of corporate supervision on a combination of ownership and management, the significant role of the state as owner, and the fairly marginal relevance of external market mechanisms.

The key characteristics of corporate governance in Russia are, on the one hand, the result of certain legal regulations concerning the corporate sector. On the other hand, however, they emerge from the unwritten, informal customs or patterns of behaviour of the so-called informal institutions. When the role of corporate legislation is being defined in the literature, informal institutions are usually an ignored element in the analysis of the corporate governance system in Russia, which may also be observed in relation to highly developed countries and the governance systems they developed.

The article’s main thrust is to analyse selected informal institutions which were considered the most significant from the Russian corporate governance system point of view. The descriptive research method was used, mainly on the basis of Russian scientific publications and international organizations’ reports. The author assumes that informal institutions influence the specificity of the corporate governance system in Russia and its particular elements and upon the efficient functioning of supervisory mechanisms. In the first part of the article, the role of institutions in corporate governance was explained. The second part includes a short description of the corporate governance system in Russia. The third part describes selected informal institutions, crucial from the Russian corporate governance system point of view.

2. Informal institutions as an element of corporate governance systems

Any analysis of a corporate governance system should include institutions. It will consequently enable the demonstration of its full specificity. According to the most frequently quoted definition developed by North, institutions are frames invented by people which shape political, economic, and social interactions. Institutions are patterns of behaviour imposed from the outside or adopted by entities as their own when they are focused on their own benefits. The literature divides institutions into formal and informal. Formal institutions include: constitutions, laws, and property rights. Informal institutions, on the other hand, are unwritten constraints, such as: sanctions, taboos, customs, traditions, or codes of conduct.

4 D.C. North, op. cit.
The evolution of a corporate governance system is influenced by certain institutions, either formal or informal. The evaluation of the role of formal institutions mostly demands an analysis of the legal system. Legal acts for joint-stock companies, the banking system and creditor protection, and the possibility to participate in ownership of certain entities, e.g. banks or the capital market, including demands related to its transparency and protection of interests, have a direct or indirect impact on corporate governance and determine the relationships between particular stakeholders. Additionally, national governance systems are influenced by regulations concerning state-owned companies, bankruptcy, reporting requirements (accounting), competition policy, and antitrust policy.

Informal institutions also influence the specificity of national corporate governance systems. Incorporating informal institutions into their research allows researchers to partially explain the characteristic features of certain internal governance mechanisms, the efficiency of market mechanisms’ activity, and the level of law enforcement, abuses and informal practices. Informal institutions may, on the one hand, improve the quality of corporate governance in a particular country, especially when formal institutions are not fully efficient e.g. legal solutions. On the other hand, however, they are also able to undermine or distort the activities of formal governance institutions, including the legal system. The full role of informal institutions in corporate governance has not been properly verified yet (if it is possible at all) and the study of relationships between informal institutions and corporate governance practice is still rare and has been conducted only in recent years, however, they undoubtedly are essential and can serve to acknowledge the exact specificity of particular national governance systems.

3. Brief characteristics of corporate governance in Russia

The dominant mechanism of corporate governance in Russia is the ownership structure. According to the results of research conducted by every leading scientific research centre in Russia, the ownership structure of companies in Russia is characterized by a relatively high level of concentration, which results in the dominant owner exercising control over the company. Dominant owners participate directly in managing companies, which results in a combination of ownership and control. The demand for external managers who are not owners is very much limited. A significant aspect in the analysis of the ownership structure of companies in Russia is

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7 Institute for Industrial and Market Studies at Higher School of Economics in Moscow, Centre for Economic and Financial Research at New Economic School in Moscow, Gaidar Institute for Economic Policy, Russian Economic Barometer.
8 Т.Г. Долгопятова, Концентрация собственности в российской промышленности: эволюционные изменения на микроуровне, “Журнал Новой Экономической Ассоциации” 2010, No. 8, p. 80.
the participation of the state in this ownership. State companies function in every sector of the economy and prevail in industries such as: infrastructure, extraction, arms, financial services and the media.

In the Russian corporate governance system, the capital market and the market for corporate control perform a secondary role, mainly because of the relatively slow development of individual market institutions and low standards of observing minority shareholders’ rights. The capital market in Russia is considered to be relatively narrow in terms of sector diversification and variety. The market is dominated by industries in the following sectors: extraction, petroleum, gas and construction.

4. Selected informal institutions as an element of corporate governance systems in Russia

One of the main problems concerning the Russian corporate governance system is not the question of the quality of legal acts but the actual practice of implementing and executing the law (правоприменение). It is caused by the fact that the functioning of the Russian corporate sector depends on informal practices which are not transparent to outsiders and can be treated as abusive in the field of corporate governance. Those institutions had a great impact on the redistribution of ownership, especially in the 1990s, by not allowing outsiders to participate in ownership. They also indirectly affected the character of other corporate governance mechanisms.

The level of protection of private owners’ rights is one of the essential factors determining the quality of corporate governance in Russia. The problem of ownership rights protection is extremely important for Russia, because the concentrated ownership structure is typical for Russian companies with one or a few majority shareholders. Inefficient legal institutions combined with weakly developed market mechanisms result in the occurrence of opportunistic behaviours towards minority shareholders. Present in Russian companies, especially in the 1990s, the following identified methods of not obeying minority shareholders’ rights can be distinguished:

(1) transferring incomplete or untrue information concerning the company,
(2) not obeying procedural requirements when voting at the General Shareholders’ Meeting,
(3) imposing charges for shareholders’ participation in the General Meeting or establishing a minimal number of blocks of shares allowing them to vote for the governing bodies,


(4) manipulating shareholders’ votes in order to gain the right to full management of votes,
(5) infringement of proper dividend payment order,
(6) the so-called ‘dilution’ of blocks of shares belonging to minority shareholders, i.e. reducing the profit from one share, e.g. by issuing extra shares,
(7) creating obstacles for the external sale of shares by their owners,
(8) bogus companies issuing and allocating new shares at a lowered price without informing shareholders,
(9) manipulating shareholders’ registers,
(10) adopting provisions in articles of associations that discriminate certain groups of shareholders,
(11) infringement of provisions related to the election of members to the board of directors,
(12) obstacles for allowing external investors to the boards of directors,
(13) opposing the external independent financial audit of joint-stock company activity,
(14) the selling of a joint-stock company’s assets at lowered value by bogus companies or to bogus buyers, without giving prior notice to other shareholders.

After the crisis of 1998, further infringements of shareholders’ rights were committed, including, among others: issuing securities without their state registration, activity on the securities market without holding the proper license of a professional market participant, violations committed by registrants, charging higher prices for services, violations committed by depositaries, not obeying transparency requirements by the state. All those examples may be regarded as the attempts made by regional authorities to cancel the issue of securities.\textsuperscript{12}

General assessments of the level of obeying shareholders’ rights and freedoms in Russia are made by selected international institutions. Such information is delivered by, among others, the International Property Rights Index. Russia’s position concerning the general index seems to be very low – 63\textsuperscript{rd} out of 70 surveyed countries in 2007 (with an index value 3.2 out of 10), and 81\textsuperscript{st} out of 129 countries surveyed in 2015 (4.5 out of 10), which puts Russia in 14\textsuperscript{th} place in the group of 19 surveyed countries of Central and Eastern Europe (Table 1). A detailed analysis of the described index components explains Russia’s low assessment results. The lowest scores, both in 2007 and in 2015, were given in the field connected with judicial independence and corruption control.

Since 2006, also within the Doing Business report conducted by the World Bank, the level of protection of investors’ rights has been studied (connected with the protection of minority shareholders’ rights against abuses carried out by managers and majority shareholders). The assessment of this index in Russia fluctuates around grade 5 (where the highest possible grade equals 10). While in 2007 Russia occupied the 60\textsuperscript{th} position out of 175 surveyed countries, in recent research it has

\textsuperscript{12} А. Радыгин, Перераспределение прав собственности в постприватизационной России, “Вопросы экономики” 1999, No. 6, p. 73.
been 100th out of 189 surveyed countries. This may mean that other countries are systematically improving standards when it comes to obeying investors’ rights and Russia does not show any true progress in this field (Figure 1).

Table 1. International Property Rights Index for Russia in 2007–2015.

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<td>Index value</td>
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<td>(63)</td>
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<td>Number of surveyed countries</td>
<td>70</td>
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Explanatory note: Russian position in rankings was given in brackets.

The infringement of minority shareholders’ rights by dominant shareholders still constitutes a serious problem for corporate relationships in Russian companies. It is indicated both by international comparative studies and studies conducted by Russian research institutions. For foreign investors, the belief in abuses committed by the managers of Russian companies is the main obstacle when it comes to investing in Russia.¹³

Strong relationships between companies and authorities at all levels are the characteristic feature of the Russian corporate governance system. They exist not only due to the direct participation of the state in selected mechanisms of corporate

¹³ НСКУ, Национальный доклад по корпоративному управлению, Выпуск 6, Москва 2013, pp. 80, 242–265.
governance (company ownership structure, boards of directors, the corporate governance market, and the capital market), but also in the form of corruption as well as informal bonds and relationships from the period of the centrally planned economy and that were partly developed in the period of the economic transformation.

Kurbatova and Levin distinguish three spheres of mutual relationships between authorities and companies: the so-called white sphere (covering formal practices and relationships that result from legal acts), the black sphere (informal practice with a criminal character, especially corruption, the setting up of private companies by clerks who then benefit from the performed function), the grey sphere (collecting informal payments from companies, not directly connected with corruption, and informal connections between companies and authorities).  

Within the grey sphere, the authorities-companies relationships are marked by the inter-relation of formal and informal norms and rules, by the dominance of the former, and the character of informal relationships that does not directly breach legal norms. Such a model of relationships between authorities at various levels and companies can lead to certain consequences for corporate governance – in the field of ownership redistribution, filling posts in boards of directors, obtaining credit, transactions on the corporate governance market, or taking advantage of the bankruptcy mechanisms.

Within the 20 years that have passed since the beginning of the economic transformations in Russia, the grey sphere was composed of three stages of shaping the informal bonds between authorities at various levels and the corporate sector. The first stage covered the 1990s (until the crisis of 1998) and is referred to as ‘state capture’ (захват государства). It was typical in that period for entrepreneurs to have an impact on the creation of legal acts or on authorities’ statements for transactions connected with privatization. This kind of model was possible on condition that the state was weak and was not able to oppose the impact of private interest groups.

In the period of the most intensive privatization (1993–1995), during the presidency of Boris Yeltsin, close connections were established between the first oligarchs and the emerging capital groups with authorities, which let them directly influence state politics. After the crisis, especially in the early 2000s, a considerable alteration in the character of informal relations between authorities and entrepreneurs took place (the so-called взаимовыгодного обмена stage, mutually beneficial for both parties). It started to become obvious that there was a division of big companies and capital groups into those that were loyal to the authorities and all the rest, with respect to the rule of ‘equal remoteness’ of companies from the authorities. Together with the acquisition of power, President Putin began numerous processes that were to alter the essence of the relationship between the state and the sector of

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16 Ibidem, p. 37.
big enterprises. One of the signs of those alterations was the so-called Pact from July 28, 2000 concluded between Putin and 19 owners of big enterprises, which aimed to regulate new mutual relations.\textsuperscript{17}

After the year 2000, the possibilities of taking advantage of informal contacts by owners of the biggest Russian companies and groups with representatives of the public authorities did not become weaker but they underwent transformations, i.e. they moved their influences from the federal authorities to regional ones.\textsuperscript{18} From the second half of 2003, a gradual change in state-companies’ relationships began. It was indicated by the consolidation and nationalization of numerous groups and companies (as well as the recovery of formerly lost assets) and the creation of new state-owned holding companies. Additionally, there were staff changes in state-owned companies and groups. This period, especially after the crisis of 2008, is referred to as ‘enterprise capture’ (захват предприятий). It is the result of the continuing expansion of the state in the Russian economy and it means that, in practice, no big enterprise can function and take important decisions without the consent of the state.\textsuperscript{19}

One of the signs of the strong relationships between the companies sector and the authorities is corruption. Corruption is considered to be the main obstacle for the development of a system of corporate governance and investment in Russia by foreign entities. It leads to the bad international reputation of the country in this field.

Diegtiarev and Malikov, when studying corruption in the Russian economy, suggest understanding it as:\textsuperscript{20} a systemic, overall economic phenomenon that describes the measures of inefficiency of public institutions and the legal system (a transaction cost), the set of strategies for the functioning of particular social groups which aim at making use of public services, and clerks taking advantage of the rights that are linked with their post, which means taking certain decisions that may breach legislation or unwritten legal norms in order to gain private financial advantage.

An assessment of the level of corruption in Russia is partly possible thanks to the \textit{Corruption Perception Index} analysis made by Transparency International. According to the results of the research carried out for Russia, it is a country with a very high intensity of corruption. Over the years 1996–2011, the index value did not exceed 3 points (out of a possible 10), and in the years 2012–2013 30 points (out of a possible 100), which shows that Russia is considered a highly corrupt country. The index values deteriorated after the two crises – in 2000 and in the years

\textsuperscript{17}В. Волков, Проблема надежных гарантий прав собственности и российский баранят вартиальной политической интеграции, “Вопросы экономики” 2010, No. 8, pp. 13–14.


\textsuperscript{19}А. Яковлев, Ю. Симачев, Ю. Данолив, Российская корпорация: модели поведения в условиях кризиса, “Вопросы экономики” 2009, No. 6, p. 75.

2008–2010. In 2015, with a result of 29 points, Russia found itself in 119th place out of 168 countries. Its results have not improved in spite of progress in economic reforms or changes in legislation made after the 2008 crisis.

According to the research carried out by the INDEM fund (Информатика для демокрации), the value of the corruption market of the Russian public sector in 2001 amounted to almost 34 bln dollars and at the turn of 2004 and 2005 to almost 320 bln dollars, which meant an increase of almost 9.5 times. The amount given as a bribe rose significantly as well – from 10 to almost 136 thousand dollars, despite the drop in the average number of bribes given. At the turn of 2004 and 2005, the value of the corruption market of the Russian public sector constituted 54% of Russia’s GDP.

The analysis of public sector corruption at the public authority level indicates that at the beginning of the previous decade, the biggest value of corruption was connected with authorities at the municipal level – about 75% of the whole corruption market of the Russian public sector in 2002 (about 20% at the regional level and 5% at federal level). In line with Troika Dialog investment bank’s estimations, Russia’s reputation as a country decreases market capitalization by about 45 bln dollars annually. The World Bank’s estimations demonstrate that in 2010, the profits from corruption constituted about half of Russia’s GDP.

From the corporate governance point of view, the corruption of the public sector is the main negative phenomenon. It makes the corruption sector dependent on the authorities at various levels and it should be recognized as a specific feature of Russian corporate governance. In the coming years it may become the main factor limiting the quality of the improvement of corporate governance in Russia.

The reasons for corruption in Russia may be justified partly by the its past, but also by the mistakes in the implemented economic reforms as well as by taking advantage of the period of economic reforms and mistakes made by new institutions when taking over state assets. One of the main factors which escalated corruption in Russia was the commencement of the privatization process. It was a redistribution of state assets that was spread over time, which, due to the lack of perfect legal solutions for privatization methods, led to the abuse of possibilities to dispose of state properties by the clerks. It was exacerbated by the scale of privatization and weakness in control over its implementation. Corruption also had a significant influence on the activity of the corporate governance market. After the crisis of 1998, it helped the redistribution and consolidation of ownership most of all. Due to this, corruption was an efficient tool that enabled illegal acquisitions. Additionally, it was used to carry out bankruptcy procedures, especially when it helped to limit the independence and work quality of courts.

26 L. Goczek, Przyczyny korupcji w krajach postkomunistycznych, “Gospodarka Narodowa” 2010, No. 4, p. 67.
5. Conclusions

Over the last twenty-plus years, the main mechanisms and institutions of corporate governance in Russia have been developed, and Russian companies, especially public ones, are systematically improving their internal governance standards. Russian corporate legislation, according to the assessment made by researchers, from a formal point of view, is well enough developed, but there are significant problems with its implementation, which still seems to be the main problem of the legal system in Russia.

The specificity of the corporate governance system in Russia depends to a great extent on informal institutions, which are not always recognized and which, due to informal practices and relations, influence the efficiency of the activities of certain governance mechanisms as well as the relationships between them. A significant problem is the infringement of minority shareholders’ rights, which constitutes one of the main factors that discourage foreign investors, including institutional ones, from investing in Russia. Corruption and the tendency to provoke corporate conflicts should also be added. In spite of the fact that the research and verification of particular informal institutions met many obstacles, it seems necessary to conduct further analysis of this issue, because without it, the knowledge of the national corporate governance system is incomplete.

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