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Saratov entrepreneurs convene a business forum
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Business in the Russian Provinces: Playing Cat-and-Mouse with the State

Andrei Shenin

From the business community's perspective, the Russian government sometimes seems to have a split personality. One day, the state shows support for the business community as a pillar of Russian greatness. The next day, the state seems to view businesses as little more than a taxable cash cow to cover budget needs. On "pillar" days, authorities create stimulus programs, cut taxes, and implement pro-business policies and initiatives. On "cash cow" days, they introduce new regulations and taxes, unleash waves of inspectors, and disregard feedback from the business community.

The confusion is compounded by a lack of coordination between the center and regions, creating a bewildering patchwork of assistance and regulations.

This most negatively impacts micro, small, and medium business that lack the financial resources to lobby for their interests in the Russian Parliament. To the business community in the provinces, the Russian state, federal and regional, resembles a multi-armed Shiva, a god that gives with some hands and takes away with others.

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A textbook example of this dynamic can be seen in Saratov oblast, a large region approximately the size of Austria with a population of 2.5 million people and a developed industry. In Saratov, entrepreneurs try, and often fail, to negotiate the federal and regional patchwork of government incentives, regulations, and fees in the pursuit of profit while avoiding fines (or even jail time).

Saratov Business, Past and Present

During the 2000s, Saratov experienced its share of economic ups and downs. But over the past decade, its economy has grown significantly: Agricultural production has grown from $550 million to $1.1 billion; manufacturing has grown from $600 million to $2.5 billion, and transport and communications has grown from $3.7 to $9.45 billion. In contrast with Russia's national economic growth led by energy exports, the Saratov region emerged as a center of small and medium business activity with a growing entrepreneurial community. But that was then—this is now.

"At the turn of the century, business life was easier, in spite of interest rates of over 20 percent and the absence of governmental support programs," Saratov entrepreneur Roman Repin said. "Of course, we were under government control and pressure, but in those times inspectors had a more 'loyal' attitude toward petty offenses. Back then, we could come to an understanding with them. I don't mean corruption schemes between a businessman and an inspector, but a human-to-human conversation!"

Surviving the State: Problem #1 for Business

The Russian government relies on the business community to pay taxes to fund the Kremlin's foreign and internal obligations. The fact that businesses also employ people and provide vital corporate social responsibility support for the regions where they operate is important to the state, but not as important as meeting the demands of the budget. For their part, businesses and entrepreneurs understand that taxes are necessary to pay for roads and essential services. They recognize that regulations are needed for consumer safety and regulating commerce. But those taxes and regulations too often rise to the level of killing the very enterprises that sustain the economy and provide the nation and the regions with a tax base.

For example, the nation's trucking industry pays taxes on fuel and vehicle horsepower. When the Russian government introduced the "Plato" system, designed to monitor and assess a tax on the miles driven by each truck, drivers protested. The new tax had the potential to cut their earnings in half. As a federal tax, the funds would do nothing to improve the regional roads that were in dire need of repair. From November 2015 to November, 2016, Plato collected almost 20 billion rubles, for which only 1,000 km of roads were repaired, according to media reports and the Russian Association of Carriers. Not least of all, the system was a product of a political insider, Igor Rotenberg. Drivers were angered by the idea of paying an additional tax to enrich an oligarch.

Another example concerns alcohol production. Entrepreneurs certainly recognize that the industry must be regulated, but the government recently instituted a requirement for producers to install special hardware and software to conform to the Russia's EGAIS system. The cost of compliance with EGAIS can range from 30,000 to 200,000 rubles. The government does not offer support for companies to cover this new expense.

Pushed to the Shadow

The practical result for many small companies is that they are pushed into the shadow economy. In Russia, the shadow economy or black market does not necessarily refer to illegal activities such as drug or weapon sales. It more commonly refers to business activity conducted without registration with the Federal Tax Service of Russia. It can include individuals such as Uber drivers, interior decorators, or tutors. It can also include what would normally be a public business, such as cargo shipping or restaurants. The attraction of operating in the shadow economy is simple to understand: The government cannot tax, inspect, and fine you if it does not know about you. Yet operating in the shadow economy has its drawbacks—including limits on economic growth and opportunity, as well as the risk of eventual arrest by the local or federal government. Many if not most entrepreneurs and business owners would much rather operate in the open, if presented with a manageable regulatory and tax environment from the state.

The allure of operating in the shadow economy becomes even stronger when comparing the cost of complying with, as opposed to breaking, the law. The fine for illegal business activity is just 2,500 rubles (about $40). Hiring an accountant to fill out complicated tax forms can cost at least 3,000 rubles (about $48), while the fine for not having a complete tax form is just 1,000 rubles (about $15). Entrepreneurs look at these figures, and often conclude that it is easier to operate in the shadows than to deal with the state.

However, it is remarkable that even when inspection bodies get information about illegal business activity, they have few ways to fine lawbreakers, thanks to a combination of bureaucratic complexity and a lack of staff. For example, according to law, only the Police Department for the Execution of Administrative Law is entitled to launch the process of closing illegal business, but one of Saratov's central districts has only one such police officer. Clearly, one officer cannot enforce the law governing such a widespread problem in a territory with a population of 300,000 people. Another absurd episode concerns the head of a local administration who was fined by prosecutors after complaints from illegal dealers on his "unauthorized" attempts to close their illicit enterprises.

From national policies to regional enforcement, government often emerges as "Problem #1" for entrepreneurs and business owners. The problem is only getting worse, pushing more and more economic activity into the shadows. According to the statistics provided by Saratov Office of the Federal State Statistics Service, over the period December 2015-September 2016, almost 31% of Saratov's small enterprises closed. Experts believe

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that many, if not most, of these closures represent businesses who shifted into the shadow economy.

The Saratov government has found that the most effective method to reduce the shadow economy is not to punish illegal entrepreneurs, but encourage them to acquire legal status by purchasing a special "patent." The patent is a special document that allows an individual to conduct business without incorporating as a legal entity or paying regular taxes. One need only purchase a one-year patent and transfer a payment to the State Pension Fund. Under this initiative, the number of shadow entrepreneurs purchasing patents grew from 180 to 730 from 2013 to 2016. The amount of tax funds these patents from newly legal entrepreneurs to the regional budget rose by 3.7 times, from $120,000 to $448,000, over that period.

Who Inspects the Inspectors?

The biggest Russian business public interest group, Opora Rossii (Support of Russia), reports that there are at least 30 inspection bodies at the federal level (plus several more at the regional/local levels) which have the authority to conduct scheduled or unscheduled business inspections. The business community acknowledges the need for inspections, but given that each agency has its own rules, entrepreneurs are simply unable to keep up with the multiple changes in regulations put out by every government agency. Moreover, from time to time these rules conflict with each other, with absurd consequences. For example, at one office a fire inspector insisted that an entrance door had to open outwards for easy escape in event of fire. Later on, a security service officer required the building to install an inward-opening door to make it easier for police to force entry in the event of a hostage crisis. Therefore, the building owner must reverse the entry door depending on who conducts the next inspection.

Another headache for business in Saratov is the Regional Department of Labor. The current director has stated frankly that his department "is always on the employee's side." As a consequence, any complaint from a worker (even a baseless complaint) frequently leads to an inspection and eventually a fine. In another case, Rospotrebnadzor (Federal Service on Surveillance for Consumer Rights Protection and Health) fined an enterprise for the improper size of a large exterior sign name-board that was smaller by only a couple of centimeters than required by Rospotrebnadzor's standards. Inspectors justified the fine by claiming that people wouldn't be able to read all the necessary information about the enterprise on such a small plate and "could be deceived."

There may be an explanation in common behind these episodes. The president of Opora Rossii Alexander Kalinin observed that. "If an officer inspects an enterprise and doesn't fine it, the head of his department may accuse him of corruption. That's why inspectors say that 'it's better to ticket than to risk it.'"

Business owners had problems with inspections in earlier times, but today's growing bureaucracy makes keeping track of all the changes in rules and laws almost impossible. To help resolve the problem, the Russian government started an initiative in January 2016 to stimulate business activity by introducing a three-year "supervisory

Meeting with Saratov Region Governor Valery Radayev and residents of the region. Source: http://en.kremlin.ru/

break" that exempts micro and small business from scheduled inspections (unscheduled inspections or inspections prompted by complaints remain). Generally speaking, the business community found the measure to be relatively effective, though Opora Rossii's Kalinin contends that nothing has changed—scheduled inspections simply transformed into unscheduled inspections. He predicts that the overall number of inspections will continue to grow.

To protect themselves from inspections, entrepreneurs can turn to the "On Self-Regulated Organizations" law that allows them to create professional associations (SROs). In accordance with the law, businesses within an SRO regulate themselves, while governmental bodies conduct scheduled inspections of no more than 10 percent of SRO members. The benefit of this law is limited, however, because typically only medium-sized or larger businesses establish SROs, while micro and small enterprises are still "hiding in the shadow," mistrusting officials and laws. The executive director of Opora Rossii-Saratov, Nikolai Asafyev, observed that the Russian system attempts to regulate the economy through inspections and bureaucracy, but ultimately the severe control it seeks to implement means nothing: "The Russian writer Saltykov-Shchedrin once said 'The severity of Russian laws is softened by the fact that obeying them is optional.' It means that illegal businesses can work in complete safety, because the authorities lack the resources to control even the legal businesses."

Interactions with the Russian government

Besides the SRO mechanism, the Russian business community also creates non-governmental organizations (NGOs) that enable business leaders to interact with officials collectively. The most prominent business NGOs include Opora Rossii, Delovaya Rossiya, and the Torgovo-Promyshlennaya Palata (Trade and Industry Chamber). These groups regularly hold meetings with governmental bodies and individual officials to discuss business problems or economic programs. The government uses these consultations with NGOs in order to correct and improve its current and future plans and policies.

In Saratov, for example, a very active cell of Opora Rossii, financed by membership fees, seeks to establish strong connections with authorities and support its member businesses through educational events, fellowships and programs, legal aid, mutually beneficial cooperation among its members, and providing campaign support to business-friendly candidates for the regional parliament. In the richest Russian cities, such as Moscow, Saint Petersburg, Yekaterinburg, or Vladivostok, Opora Rossii has its own lawyers and experts that monitor inspections of its members' enterprises. In smaller cities, the small population of entrepreneurs tend to worry more about their individual survival than about business community problems in general. As a result, in small cities the influence of such NGOs is far less. Opora Rossii-Saratov's Nikolai Asafyev reports that NGOs in Saratov previously had a reputation for not standing up to officials. Active citizens who tried to press for participation in various state initiatives were not welcome in these NGOs that were more concerned with protecting relationships with state officials. "However," Asafyev says, "President Putin's order on providing governmental support to the most active NGOs can turn this 'one-way street' into a real working mechanism—allied with the Kremlin, but functional. This inspires hope, because before these NGOs resembled hobby-clubs and talking shops, rather than effective groups."

Following Putin's orders, local officials do try to support businesses and keep a proper balance between enforcing taxes and regulations and implementing programs to support the business community. In Saratov, for example, the regional government provides several very interesting and promising projects to assist local business. However, each program has problems:

1. The Microcrediting Fund is a governmental financial organization that provides microloans for business (up to $50,000) at the relatively low interest rate of 9-11 percent per year. Many entrepreneurs have received loans without serious problems, but those who were rejected claim that they were required to find two warrantors with an official income of 300,000 rubles (the average salary in Saratov is 25-30,000 rubles). While the fund works well in granting credits to businesses, there are rumors that a large share of the Fund's money is distributed to "credit rentiers" who turn around and relend the borrowed funds at a higher rate (20 percent or more). Some businesses are ready to pay such a rate, particularly the majority of small businesses working in the shadow economy that cannot provide official documents. Moreover, the interest rate

charged by banks can reach 25-35 percent per year (once the purchase of additional services such as insurance or audits is included).

2. The Business Incubator Program consists of dedicated office buildings that offer space for a little rent, free legal aid, and grants to first-time entrepreneurs. Renting an office at the Incubator seems a good deal for entrepreneurs looking to save money, but the location is not ideal and there is a general lack of awareness that the program even exists.

3. Officials work with banks to make "soft loans" available for business. The issue is that banks are very cautious about lending money after the banking collapse in the latter 2000s. The federal government is implementing a new promising program, "6.5," under which The Bank of Russia distributes credits that are intended for small and medium business through a web of Russia's eleven biggest banks. These credits are offered to the banks at a rate of 6.5 percent, and the banks are permitted to charge 10-11 percent to businesses, which still represents the lowest rate on the market. The problem is that the minimum credit line available is 50-55 million rubles (almost $1 million). A typical small-to-medium Saratov business is simply unable to make a profit while covering the annual 10-11 percent rate on a credit line of that size.

   Obtaining regular bank credit is also very difficult. Not only are the interest rates high, banks now regularly reject loans even to prominent companies that have a demonstrated capacity to repay loans. Last year, Saratov banks halted virtually all loans to construction firms. Many banks ceased lending activity altogether in the wake of the Central Bank's purge of high-risk banks. The number local banks in the regions dropped, often leaving some regions with only branches from one of the top national banks. Out of caution, most national banks transferred loan authority away from the branches to the central administrations in Moscow, where managers have no idea about situation on the ground and deny requests from even the most reliable companies.

   Considering these many barriers in the credit market, the process of obtaining business credit seems to be a mission: impossible. A common sentiment among entrepreneurs is: "Better to sell your Grandma's apartment for your start-up budget than to mess with banks." More advanced entrepreneurs take this idea a bit further: they buy apartments in Europe to serve as collateral on contract loans in European banks at a rate of 3-4 percent.

One businessman I spoke with lacked confidence in the state's efforts to help business: "Business incubators and micro-lending funds are just a drop in a sea. Even if they helped someone, it has little impact on the general business climate. So, we can't speak about serious support for business in Saratov region. We can hope that in other regions things go better."

The Kremlin and local governments also view government contracts as a vehicle to support business. While the Russian state is usually reliable about paying its contractors, the situation in the regions and cities can be far different.

Russian companies in the regions know that there is a definite risk that a regional or municipal government will not render payment on a contract, requiring the contractor to go to court to secure a judgment requiring payment. Even with a judgment in hand, a contractor may still have problems getting paid. Regional and municipal governments often set aside a budget for paying off such judgments, and when that budget is exhausted for the year, those still holding judgments against that government must wait until the next year. In 2016, the Public Prosecution office of the Russian Federation worked to force local governments to pay these debts more quickly, but it remains a significant problem.

In case of long-term contracts, vendors must be ready for unexpected budget changes from parliament that can shift money from a signed contract to "more important" tasks. This puts contractors in a trap – they know that they won't get paid, but they can't stop work on the contract out of fear that they will be blacklisted as an "unreliable partner." The only recourse for them is to finish the contract and try to get a judgment forcing payment through a court decision. While such cases are very rare, entrepreneurs do need to think twice before bidding on contracts from local or regional authorities.

The Russian government attempts, at both the federal and local level, to create a positive business environment for small business through new programs, easy-term loans, and "supervisory breaks." However, when these initiatives manage to filter down to the regional level, local authorities attach additional rules and conditions. Banking services that are available to companies in larger cities are often absent in the regions. Stringent conditions and pressure on business from inspection bodies on the ground have made entrepreneurs very cautious about any interactions with the authorities. The resulting business environment has led many of them to prefer to operate in the shadow economy. Not only do shadow businesses provide unfair competition to regular business, they degrade the chain of budget transfers: the federal budget depends on tax transfers from the regions. The regions, in turn, are required to implement the Kremlin's various business incentive programs while at the same time maximizing collection of the taxes and fines needed to pay the Federal budget.

This dizzying array of ineffective support programs, burdensome regulations that often conflict and constantly change, and aggressive and unpredictable inspections regimes leaves the regional business community at a loss on how to interact with the authorities. At the end of the day, they really have only one thing to ask: "You can keep your state support if you would please just leave us alone."

Conclusion

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The Wilson Center

wilsoncenter.org

facebook.com/WoodrowWilsonCenter

@TheWilsonCenter

202.691.4000

The Kennan Institute

wilsoncenter.org/kennan

kennan@wilsoncenter.org

facebook.com/Kennan.Institute

@kennaninstitute

202.691.4100

Andrei Shenin

Andrei Shenin is currently an Associate Professor in the L.N.Gumilyov Eurasian National University in Kazakhstan.
shenin.andrei@gmail.com

Andrei Shenin is a Russian journalist and scholar. His area of study is U.S. foreign policy, focusing on the decision-making process within the American establishment. Since 2009 to 2016, he has been working as a journalist for various Russian web-sites and newspapers, including the Saratov office of *Kommersant*.

Woodrow Wilson International Center for Scholars
One Woodrow Wilson Plaza
1300 Pennsylvania Avenue NW
Washington, DC 20004-3027