Criminal Persecution of Business in Russian Regions: Private Interests vs. "Stick" System

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Research question

- Recognition of violence as important factor of economic and social development
- Increasing attention to political mechanisms to control and limit violence
- But what about incentives of public servants responsible for the execution of state coercion?
- What kind of incentives are driven the behavior of police officers in weak institutional environment – like in Russia?

Previous studies

Ronald Weitzer (1995):

- Functionalist model (in developed democracies) – police is fighting crime
- Divided society model (authoritarian and highly polarized societies) – police serves to the interests of ruling elite

Gerber and Mendelson (2008):

- Model of predatory policing – police try to extract rent from their authority for use violence
- Main features (and differences to 'divided society model') :
  - Police corruption is present as often as police violence
  - All social groups experience significant levels of police misconduct
  - Even if elites occasionally deploy the police for political purposes, most instances of police misconduct advance rent-extraction and self-preservation rather than suppress subordinate groups

Firestone (2010), Gans-Morse (2012) – evidences of such kind behavior in relations of Russian police with business

Our contribution

- Police misconduct in Russia is connected not only to the rent extraction behavior of police. Another important reason is very formalized internal evaluation system (so called 'stick system' or 'checkmark system') deployed by the Ministry of Interior in 2003. This system is based on monthly comparison of current criminal statistics to the level of previous year and provided huge incentives to increase the numbers in reports (without links to real crime)

- Paneyakh (2011) described this distorted incentives system using the series of in-depth interviews

- In this paper using unique dataset on economic crime in Russian regions in 2004-2009 we provide empirical confirmation of the 'stick system' effects

Institutional context in Russia of 2000s - 1

- 2000-2003: a number of significant economic reforms (simplifying tax regulation and reducing tax rates – 'tax revolution' according to article in NYT 2002, deregulation of business activity, reform of custom regulation) – based on negotiations with big business
- Strengthening of 'power vertical' – including 'federal reform' with redistribution of resources and authority from regions to federal center (including the appointment of RPD heads without approval from regional governor)
- Liquidation of tax police and special police departments for organized crime; replacement of RPD heads (71 of 89); campaign against 'werewolfs in epaulets' in the Ministry of Interior (2003)

Institutional context in Russia of 2000s - 2

- 2003 – 'Yukos affair' as the conflict between business and top political elite for the control of natural rent – with clear public support of governmental pressure on big business. Political victory of Putin – confirmed by results of parliamentary and presidential elections in 2003-2004

- But as example of selective application of law 'Yukos affair' not only led to the collapse of government-business dialogue but also provided strong signal for lower level officers in law enforcement system [...*every captain or colonel in police would like to have his own small Yukos*...] => strong increase in violent pressure on business

Motorola-Evroset case (2006)

Motorola shipped the phones — seven models in all, worth roughly $17 million — to Moscow on March 20 and applied for the necessary declaration of compliance for their sale in Russia. It received approval on March 24. And on March 29, after the customs service approved the shipment, the shipment was seized. Six days later, Department K of the Interior Ministry, which investigates economic crimes, announced that it had taken the phones on a seemingly vague basis that they were "not designed for use in the territory of Russia" and, in an apparent contradiction, that Motorola's distributor, Yevroset, "concealed the fact that the phones imported to Russia were counterfeit." Interior Ministry destroyed the C115 phones, worth $2 million, on April 25, 2006 with journalists watching their destruction — after saying that one model violated safety standards, although there was plenty of suspicions that not all the phones were destroyed. But the same model remained on sale in shops around Moscow.

(***The New York Times, June 3, and June 14, 2006***)

Chemist case (2006-2007)

In the middle of 2006, Yana Yakovleva and Alexei Protsky from SOFEX Co. were arrested by Federal Drug Control Service officers – after rejection of an offer to participate in the drug shipments to Tajikistan. On February 16, 2007, the Federal Drug Control Service was compelled to set Yana Yakovleva free after seven months of illegal detention. The decision to set her free was made under pressure of strong social movement in defense of chemical industry in Russia (because such kind of violent pressure from FDCS was typical in the sector). In January 2007 meetings against repressions of the Federal Drug Control Service were held in Moscow and Samara. Nine deputies of the State Duma stood up for liberation of Yakovleva and Protsky. (http://www.himdelo.ru/)

Agromol case (2008)

Suit for criminal case was filed against Dmitri Malov in 2008 on Article 159 of Criminal Code (fraud). People in his company maintain that, exactly before filing of the case against Mr. Malov, a number of retirees from law enforcement agencies addressed him with an offer to sell them his business. These offers were accompanied with threats of criminal prosecution. After Mr. Malov rejected their offers, the regional department of Federal Security Service carried out an investigation of "Agromol" and secured opening of a criminal case. Although Dmitri Malov bought this information to the court's notice, the court did not take onto consideration, and he got in 2010 a 5.5-year prison term. After public efforts of 'Business Russia' (one of leading Russian business associations) on November 19, 2012 the Supreme Court of Russia completely acquitted Dmitri Malov due to absence of corpus delicti.

(***BBC News, 25 May 2011***)

Changes in business climate
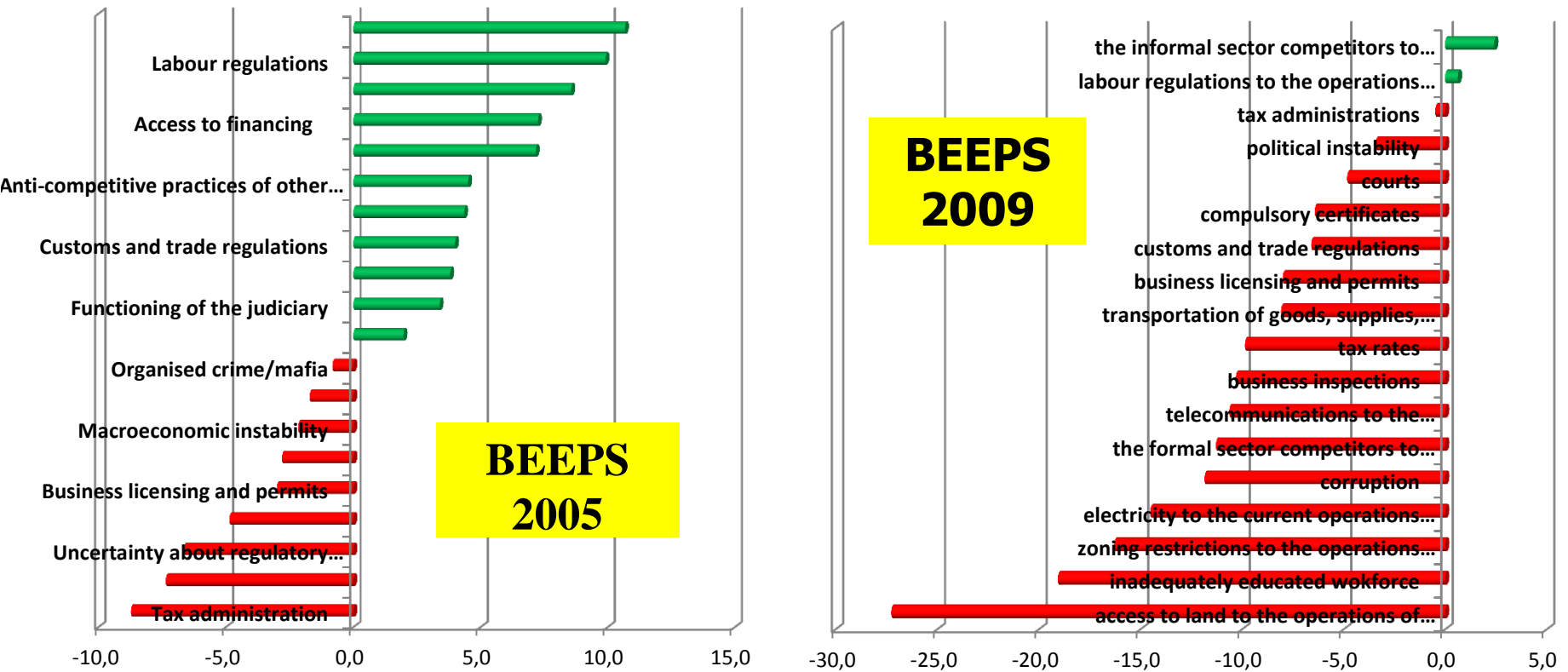
Conditions for doing business in Russia: "green = better" and "red = worse" comparing to CEE average indicators in BEEPS 2005-2009

Institutional context in Russia of 2000s – 3

- December 2009 – amendments to Criminal Code prohibiting since 2010 pretrial arrests of entrepreneurs (before they were arrested in 95% of cases)
- 2010 – reform of police (including changes in internal system of evaluation)
- 2011 – establishment of Agency for Strategic Initiatives
- 2010-2011 – public pressure from 'Business Russia' on improvement of business climate => '100 steps program' announced by Putin in February 2012. Elaboration and approval of 11 roadmaps for export promotion, simplification of access to electricity and construction permits etc.
- June 2012 – establishment of the post of ombudsman for entrepreneurs and appointment of Boris Titov from Business Russia to this position
- June 2013 – amnesty for entrepreneurs

Another part of story: 'stick system'

- Appointment of Mr. Nurgaliev as new Minister of Interior on December 31, 2003 => Introduction of very formal and strict system of evaluation of subordinated police departments based on monthly comparison of indicators of current criminal statistics to the level of previous year.
- Some consequences:
  - Incentives to increase numbers for each indicator (not depending on real crime) => registration and 'investigation' of artificial cases (only for reporting purposes)
  - Incentives to demonstrate only marginal increase for each indicator in reporting period
  - Incentives (and opportunity) for newly appointed RPD chefs to decrease the 'base level' of overestimated indicators – because according to bureaucratic rules new RPD chef is not responsible for statistics provided by old RPD chef

Hypotheses

Hypothesis 1: "Private Interests"
Law enforcers initiate criminal cases in private interests: potential gains for law enforcement officers may be associated with cash flows. If rent seeking behavior dominates we should see higher level of economic crimes in a region with higher cash flows.

Hypothesis 2: "Stick" System
- H2.1 The "stick" system creates incentives for the MIA officials to inflate the reported crime statistics. The common practice is to show a small positive increment in registered cases each year.
- H2.2 However, the year-to-year change in economic crime indicators is lower for regions with higher level of crimes in a previous year.
- H2.3 When a new RPD chief comes into office the first incentive of a new chief is to decrease "base level" of the number of criminal cases.

The MIA Data on Economic Crimes

Data on the number of economic crime (such as article 159 "Fraud", 160 "Embezzlement", 171 "Illegal entrepreneurship", 195 "Bankruptcy fraud", 198 "Tax evasion" etc.) in 83 Russian regions in 2000-2010:
- Number of criminal cases registered during a year;
- Number of cases finished with an investigation;
- Number of cases handed over to courts.

We construct proxies:
- "Entrepreneurial" articles – those which are used only against entrepreneurs
- "Mixed" articles – those which are used against both entrepreneurs and general criminals
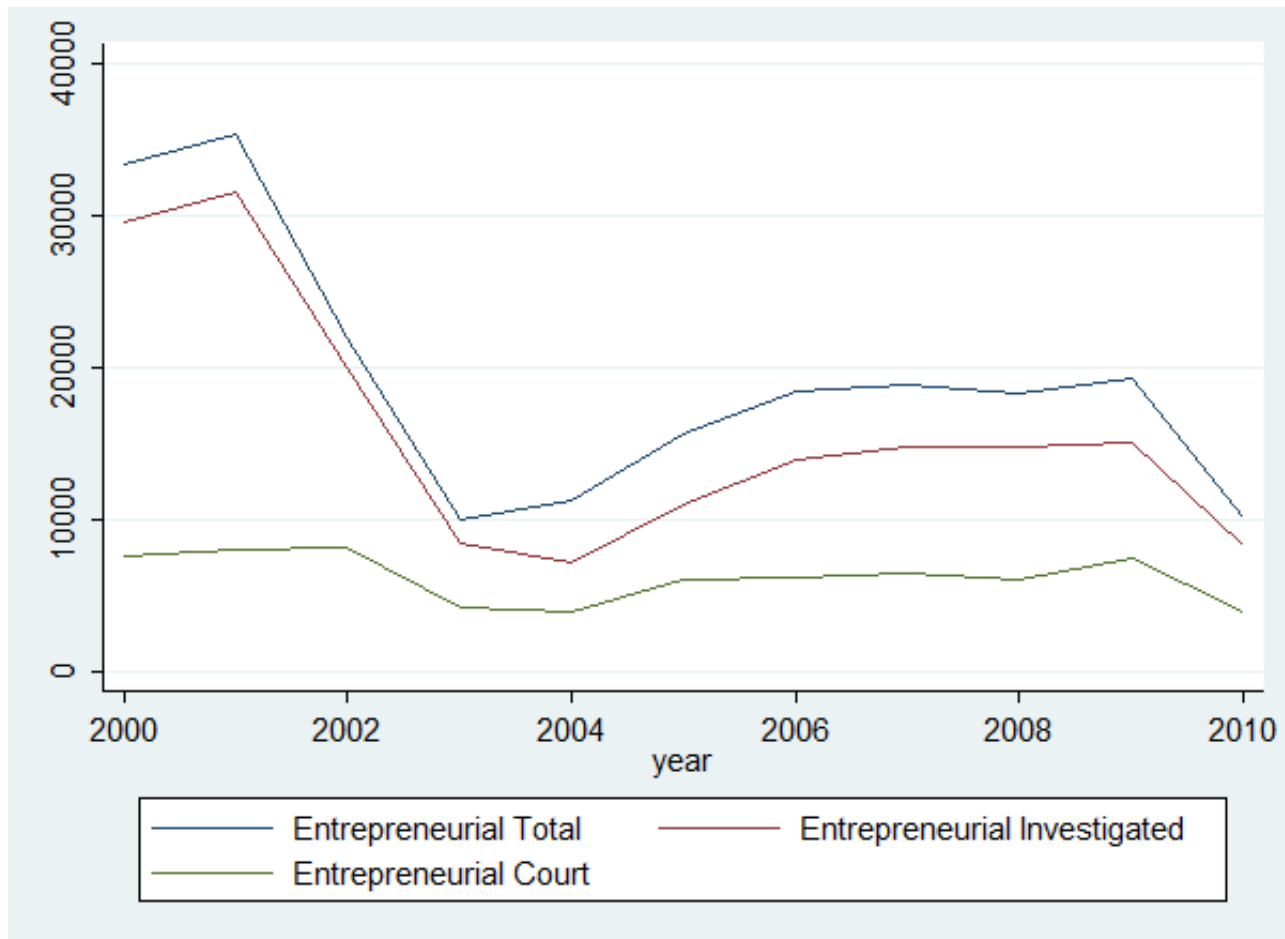
"Mixed" Economic Crimes: Dynamics

Figure 2: Number of "Mixed" Criminal Cases, 2000-2010
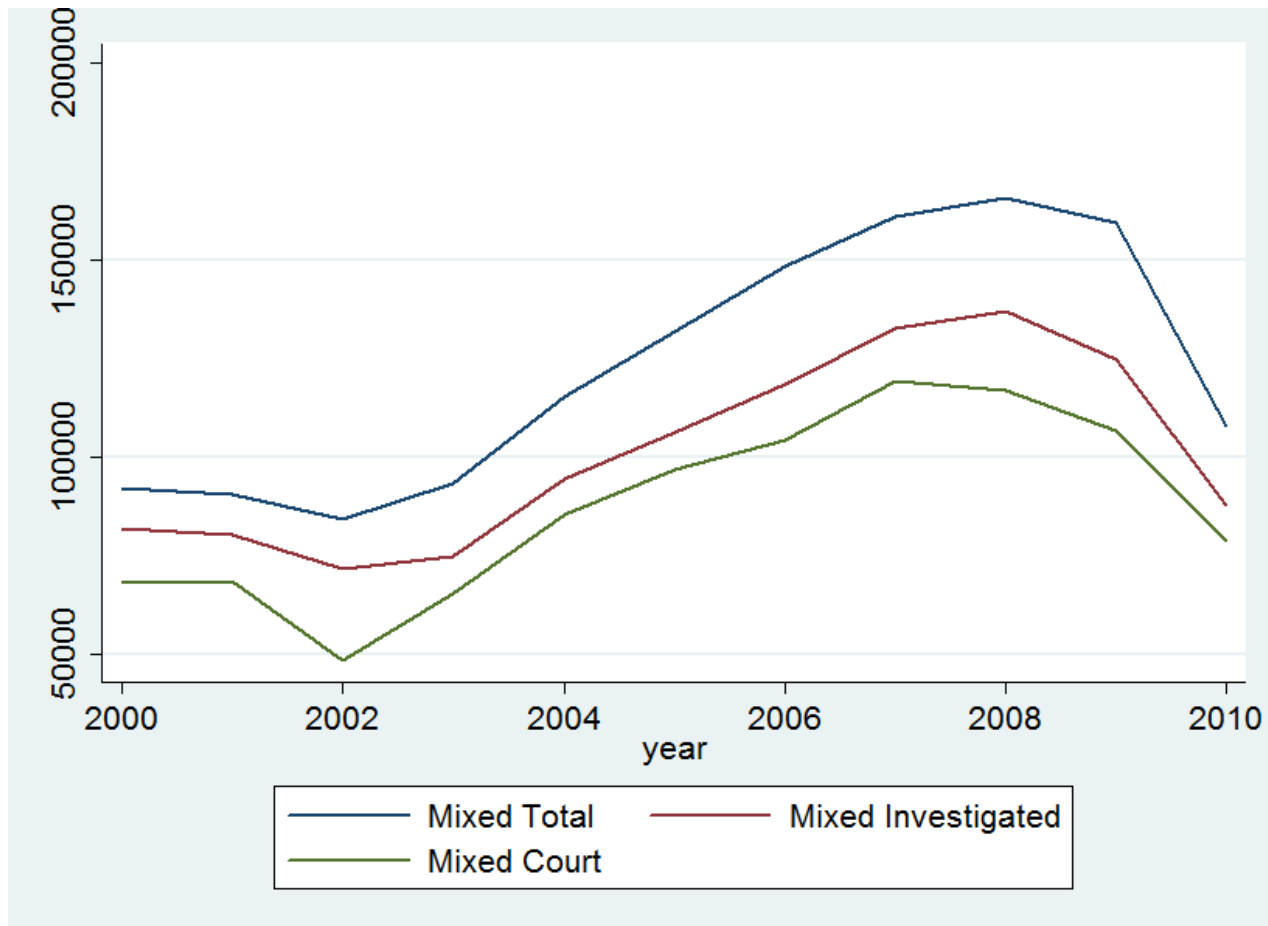
"Entrepreneurial" Economic Crimes: Dynamics

Figure 3: Number of "Entrepreneurial" Criminal Cases, 2000-2010

ICSID Political and Socio-Economic Variables

78 regions (excluding Chechen Republic, Ingush Republic, Khanty-Mansi AO, Nenets AO, Yamalo-Nenets AO), 2004-2009

RPD Chiefs' Turnover:
= 1 if a new chief of PD was appointed

Scheduled Governors' Turnover:
= 1 if a new governor was supposed to be re-elected or re-appointed during a current year (dates of re-elections/re-appointments are exogenously scheduled)

Proxy for cash flows:
Volume of retail trade, per capita, in 2000 prices (CPI deflated)

Modeling Strategy: System of Equations

- Dynamic panel data model using system GMM (Blundell and Bond (1998)) and "collapsed" instruments (Anderson and Hsiao (1981))
- Windmeijer (2005) cluster-robust standard errors (robust to arbitrary within-cluster serial correlation)

$$y_{1,it} = \rho_{11}y_{1,it-1} + \rho_{12}y_{2,it-1} + \alpha_1 z_{it} + X_{1,it}\beta + c_{1,i} + \theta_{1,t} + u_{1,it} \ (1)$$
$$y_{2,it} = \rho_{21}y_{1,it-1} + \rho_{22}y_{2,it-1} + \alpha_2 s_{it} + X_{2,it}\beta + c_{2,i} + \theta_{2,t} + u_{2,it} \ (2)$$

$y_{1,it}$ - number of economic criminal cases per 1,000 firms (logged).

$y_{2,it}$ - volume of retail trade, in fixed 2000 prices (logged).

z_{it} - dummy for RPD chiefs' turnover, s_{it} - dummy for the scheduled turnover of governors.

$X_{1,it}$ and $X_{2,it}$ - socio-economic control variables (most in t--1, logged).

$c_{1,i}$, $c_{2,i}$ - individual fixed effects; $\theta_{1,t}$, $\theta_{2,t}$ - fixed time effects.

$u_{1,it}$, $u_{2,it}$ - possibly serially correlated and heteroskedastic, cross-correlated over the equations.

Estimates: Equation 1 for Criminal Cases (in Levels)

Table 1.1: Registered and Investigated Criminal Cases Per 1,000 Firms vs. Retail Trade Volume Per Capita. 2004-2009

Equation 1: Criminal Cases	(1) Model	(2) Model	(3) Model	(4) Model
L.Criminal Cases Per 1,000 Firms (Log)	0.92***	0.94***	0.95***	0.59***
L.Retail Trade Volume Per Capita (Log)	0.39**	1.067***	0.56***	0.19
MIA Chiefs' Turnover	-0.040	-0.049*	-0.049*	-0.041
L.Share of Urban Population (Log)	-0.78**	-2.19***	-1.15***	-0.87**
L.Employed in Public Sector (Log)	0.91***	2.32***	1.28***	1.53***
Year Effects	Yes	Yes	Yes	Yes

Cluster-Robust Standard Errors in Parentheses. L — lag operator.
Model (1) Registered Mixed Cases.
Model (2) Registered Mixed and Entrepreneurial Cases.
Model (3) Investigated Mixed Cases.
Model (4) Investigated Mixed and Entrepreneurial Cases.
* $p < 0.10$, ** $p < 0.05$, *** $p < 0.01$

Estimates: Equation 2 for Retail Trade (in Levels)

Table 1.2: Registered and Investigated Criminal Cases Per 1,000 Firms vs. Retail Trade Volume Per Capita. 2004-2009

Equation 2: Retail Trade	(1) Model	(2) Model	(3) Model	(4) Model
L.Retail Trade Volume Per Capita (Log)	1.015***	1.017***	1.016***	1.013***
L.Criminal Cases Per 1,000 Firms (Log)	0.032***	0.027***	0.033***	0.034***
Scheduled Governors' Turnover	-0.011***	-0.016***	-0.010***	-0.014***
L.Share of Urban Population (Log)	-0.010***	0.003*	-0.012***	-0.008***
L.Road Density (Log)	0.007***	0.004**	0.008***	0.006***
L.Number of Small Firms (Log)	0.003*	0.002	0.003**	0.003**
L.Total Migration Growth	-0.003***	-0.003***	-0.003***	-0.003***
Year Effects	Yes	Yes	Yes	Yes

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Estimates: Equation 1 for Criminal Cases (Change in)

Table 2.1: Registered and Investigated Criminal Cases Per 1,000 Firms vs. Retail Trade Volume Per Capita. 2004-2009

Equation 1: Criminal Cases	(1) Model	(2) Model	(3) Model	(4) Model
L.Criminal Cases Per 1,000 Firms (Log)	-0.13**	-0.056	-0.044	-0.41***
L.Retail Trade Volume Per Capita (Log)	0.39**	1.067***	0.61***	0.19
MIA Chiefs' Turnover	-0.039	-0.049*	-0.048*	-0.041
L.Share of Urban Population (Log)	-0.87***	-2.19***	-1.24***	-0.87**
L.Employed in Public Sector (Log)	1.094***	2.32***	1.36***	1.53***
Year Effects	Yes	Yes	Yes	Yes

Cluster-Robust Standard Errors in Parentheses. L — lag operator.
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L.Road Density (Log)	0.008***	0.004**	0.008***	0.006***
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Main results

- In 2004-2009 (time period of dominance of 'stick system' in Russian police) the number of registered and investigated criminal cases was strongly dependent on the level of previous year
- The higher was the base level the lower was the change in criminal cases (per 1,000 cases)
- When a new RPD chief came into office he had an incentive to decrease "base level" of the number of criminal cases
- Higher cash flows in a region measured by the volume of retail trade create incentives for predatory criminal persecution, i.e. incentives for rent extraction, but "stick system" (H2) effects are larger than "private interests" (H1) effects