# Stealing Privatization

An economist argues that rule of law and robust democratic institutions are fundamental to a successful transition from communism to a free market democracy.

by John A. Gould

*They are stealing absolutely everything and it is impossible to stop them. But let them steal and take their property. They will then become owners and decent administrators of this property.*
*- Anatoly Chubais**

Assume a small entrepreneur realizes that garbage in her neighbor's backyard is reducing her annual revenue by $1,000. If she pays a garbage company to remove the refuse for less than $1,000 she will be better off. Indeed, even if she pays $999 a year for the clean up, she will still raise her total benefit by $1.

Liberal economists have used this logic to justify post-communist privatization for the past 15 years. They have argued that quick transfers of state-owned assets to self-interested private owners make it possible for individuals (like the hypothetical entrepreneur) to see and take advantage of opportunities for value-generating deals. As private owners take over from state owners, they see countless ways to avoid inefficiencies, making themselves and society wealthier in the process.

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One unfortunate characteristic of this justification for privatization was greater tolerance of corruption. The opening quote from former Russian privatization architect Anatoly Chubais demonstrates how some economic liberals believed that privatization could succeed in an environment devoid of the rule of law and robust democratic institutions. They argued that this initial "robber baron" stage of capitalism would produce owners who would eventually seek to "go legit"—restructuring their properties to turn a profit in a competitive market. This case was made by Chubais and others during the bleak years between 1992 and 1996, when the unpalatable alternative facing them was to delay privatization while state enterprises continued to suffer from politicized management, employee theft and perverse incentives.

However, hindsight has shown us that the underdeveloped political institutional environment in post-communist countries mattered to privatization's eventual success. In our opening story, for example, the entrepreneur must pay to clean up the neighbor's garbage. But under robust local democratic institutions, she might be able to fight for a town ordinance against unsightly garbage. If the political institutions backed her up, it would be the untidy neighbor who would have to pay up to $999 to clean up his yard (if it cost more than that, he might simply choose to compensate the entrepreneur for her $1,000 in annual lost value).

From an economist's perspective, this second scenario is just as efficient as the first. Both increase total value by at least a dollar. Yet the model gives no indication of how to handle the underlying question of *who compensates whom*. It envisions no standards to determine which action better conforms to society's notions of fairness, a crucial shortcoming. In the post-communist context, as it turned out, privatization was more about building power than competitive markets. The failure to realize this meant that the economists' scenario put the cart (establishing property rights) before the horse (establishing the rule of law protected by healthy democratic political institutions).

In post-communist practice, high stakes issues like privatization mattered so much to the parties involved that they were unlikely to play fairly or seek to "go legit." Most often, they strove to break the institutional fetters that bound them. Indeed, those who controlled the state often resolved conflict over property in favor of the politically connected or the financially well heeled.

In the majority of post-communist cases where transitions to democracy were either incomplete or "managed" by the communist elite, relatively strong evidence shows that privatization served as a primary vehicle for building the wealth and power of the elite. In a recent study of primary modes of post-communist privatization, I found that illiberal democracies and authoritarian regimes overwhelmingly favored "insider" groups (mostly managers and employees of state-owned enterprises) at the expense of other claimants. Indeed, privatization policymakers, such as Chubais, frequently advocated just such a solution as a means of securing insider support for privatization.

For every success story, numerous counterexamples emerged of new owners whose thirst for theft extended beyond the state enterprise to infiltrate the policies of the state itself. New owners took advantage of bribes, political contacts or simply a weak state to buy firms well below market rates, to avoid paying taxes, to win state contracts on uncompetitive terms, to secure "soft loans" from politically controlled banks and to redirect subsidized materials for sale on world markets (and direct the resulting profit to personal bank accounts abroad). There were literally hundreds of such market conspiracies—attesting to the highly creative, entrepreneurial initiative of post-communist managers and politicians.

The existence of such "conspiracies" should not be surprising to economic liberals. As early as 1776, Adam Smith warned about the tendency of "merchants and manufacturers" to conspire to restrict markets and raise prices. He did not mention political context, but one can be reasonably sure that would-be conspirators prefer not to act in the open. Indeed, the difference between the frequently corrupt privatization processes in the Czech Republic and those in a country like Ukraine was that the Czechs already had stronger democratic institutions and rule of law (relatively speaking) to protect them from *protracted* scams and conspiracies that eroded entrepreneurial confidence in the local investment climate.

The relationship between privatization and democratization was most apparent in Slovakia. Prime Minister Vladimír Mečiar inherited the highly flawed mass privatization framework from his Czech predecessors. Yet, the program's increasingly evident problems were less important to Mečiar than the fact that it provided the lion's share of benefits to groups that opposed him politically. After consolidating power in late 1994, Mečiar changed the distributional formula in Slovakia's privatization program to reward his allies and punish his opponents.

In the opening scenario of this article, either outcome should have been economically acceptable; in the end, it doesn't matter who profits as long as he/she continues to participate in the economy. However, from 1994 to 1998, Mečiar systematically undermined independent centers of authority that challenged his ruling coalition's ability to funnel property, credits, tax breaks and state contracts to themselves and their allies at the public's expense. Slovakia slipped significantly in independent rankings of democratic governance and transparency. By 1997, the European Union dropped it from its list of front runners for accession. In 1998, Slovakia was able to reverse its fortunes due to its relatively well-informed society and its ability to replace the "party of power" in relatively free and fair elections. Having rejected illiberal democratic and economic change, Slovakia returned to a more liberal post-communist trajectory—but the strain on civil society and political institutions was significant.

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Similar stories can be told about most of post-communist Europe's illiberal democracies. Some, like Croatia, Serbia, Georgia, and perhaps as I write, Ukraine, have had mostly happy endings. Yet others, like Belarus, Azerbaijan and Putin's Russia demonstrate how insider privatization portends illiberal political change. Simply put, illiberal privatization creates a group with a stake in retaining illiberal political institutions, which makes building a new liberal market democracy much more difficult. Perhaps the only hopeful lesson is that illiberal insider privatization also contributes to subsequent economic crisis—frequently a fatal challenge to authoritarian regimes.

Progress in the second decade of post-communist political development thus demands a more dynamic model of political economy than that offered by liberal economists. The blind eye economists turn to privatization-related corruption is likely to prolong the challenges of economic reform. Good policy must begin with the assumption that all unwatched political and economic agents are corruptible. Creating private owners without simultaneously building institutions empowered to protect citizens against all forms of economic and political monopoly will never be enough. Successful privatization depends on the mutual development of a liberal economy and an open political system.

** John Kay, "Don't mix politics and quest for wealth" Financial Times, July 7, 2004.*

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