Privatization and Corruption in Transition Economies

Daniel Kaufmann and Paul Siegelbaum

"If you think privatization is corrupt, try without it."

—Anonymous official, in response to the Ukrainian parliament's decision to halt the privatization program on the grounds of possible corrupt methods (1994)

Introduction and Initial Conditions

Background

The scale of privatization now underway in the transition economies of the former Soviet Union (FSU) and Central and Eastern Europe (CEE) is historically unprecedented. During the decade of the 1980s, about 6,000 firms were privatized throughout the world. During the first half of the 1990s, in contrast, well over 50,000 medium- and large-scale enterprises have been privatized in these transition economies—almost 10 times the number in half the time. Furthermore, these figures do not include hundreds of thousands of small-scale enterprises also privatized in the CEE/FSU region during the period—over 75,000 in Russia, 35,000 in Ukraine and 22,000 in the Czech Republic.

The perception has emerged, in parallel with this historic ownership transfer, that corruption has reached endemic levels

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in the transition economies of the FSU and CEE alone. While empirical evidence is naturally elusive for such activities, some micro-surveys as well as anecdotal evidence—much of it widely reported in the freer press—is suggestive. Moreover, empirical evidence now exists tracing the evolution of the unofficial component of the transition economies. For the FSU, the share of the unofficial economy's contribution to the overall economy (unreported value added as a percentage of GDP) is estimated to have increased almost three-fold over the 1989-1994 period, from 12 percent to 33 percent. Although overall output has contracted sharply during the transition, the unofficial economy has grown significantly, in absolute as well as real terms. While the increase in its share in the CEE countries was smaller, the overall share of the unofficial economy there still exceeds 20 percent. By comparison, similar measures for industrialized countries suggest that in most countries the share of the unofficial economy in GDP is in the single digits or teens.

It is reasonable to assume some positive correlation between the relative magnitude of the unofficial economy and corruption in a country, considering the practical necessity of obtaining informal support from government officials for these unreported activities. For example, an enterprise survey of 200 firms in Ukraine and Russia indicates that firms that significantly underreport their activities have also had to make higher extra-legal payments than those that underreport less.

Against this background, it is not surprising that privatization and corruption have been perceived as closely linked

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5 In this paper, the term “unofficial economy” refers to that segment of the economy that is not recorded officially. It differs from the conventional notions of the “informal” sector (or “shadow economy”) in that it mainly takes place alongside legally registered activities, undertaken by firms which officially report only a portion of their total operations. See Daniel Kaufmann and Aleksander Kaliberda, “Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework of Analysis and Evidence,” in B. Kaimsky, ed., Economic Transition in Russia and the New States of Eurasia (New York: M.E. Sharpe, 1996).  
6 ibid.  
7 Kaufmann (1997).
in the FSU and CEE economies. For these countries, privatization, in its many forms and variations, places a substantial share of the entire wealth of the economy "on the table" for sale or transfer from state to private interests. At the same time, the fiduciary controls that ordinarily operate to ensure that government transactions are fair and transparent have been largely crippled.

In this article we examine the relationship between corruption and privatization. Without privatization, the transition economies had no real hope of climbing out of the bankruptcy into which they had been placed by the central planners, with their politically-inspired, monumentally inefficient allocation of resources. At the same time, there is a growing consensus today that corruption has negative effects on the costs of doing business, on aggregate investment, and on growth. Is corruption the inevitable price to be paid for privatization? Where the transition continues, as it must, does broad-based privatization result in greater corruption than where privatization is delayed, partial or absent? Can privatization programs be designed to lessen the

8 The negative perceptions of the link between privatization and corruption started early in the transition, partly promoted by academics who targeted Russia's mass privatization program. Weisskopf writes: "Far from creating a whole country of capitalists, or even a big class of small owners, the [voucher mass privatization] scheme seems likely to serve as a convenient way for those who have already acquired vast financial resources to launder frequently ill-gotten gains." Thomas Weisskopf, "Russia in Transition: Perils of the Fast Track to Capitalism," Challenge (November-December 1992) p. 34.

9 The surprise is not that there are many corrupt officials, but that there is still a substantial core of honest bureaucrats and politicians, willing to endure personal sacrifice to bring their countries through this difficult period.

10 In theory, privatization is not essential to the transition from a socialist to a market economy. Liberalization of markets, coupled with a hard budget constraints, free entry for new firms and autonomous state enterprises with contractual profit incentives could lead to similar results. In practice, however, such approaches have consistently failed to work, primarily because governments have been unable or unwilling to honor these market-friendly arrangements or to separate politics from business decisions. See Raymond Vernon and Yair Aharoni, eds., State-Owned Enterprise in the Western Economies (London: Croom Helm, 1981), John D. Donahue, The Privatization Decision (New York: Basic Books, 1989) and Bureaucrats in Business (Washington, DC: World Bank, 1995).

corruption that occurs during their implementation? Looking past the transactions themselves, can privatization—even if corrupt in its implementation—ameliorate corruption in the post-privatization era?

Given the rudimentary nature of the literature in this area, the lack of empirical data and the relative youth of the transition, this effort should be seen as a first investigation, and by no means conclusive on the topic. Further work in this area will be needed before the issues we address here are settled. Yet the analytical approach to the links between privatization and corruption we take here, complemented by a review of the initial evidence we have gathered, do suggest certain insights that challenge conventionally held beliefs on the links between privatization and corruption. Further, in this paper we suggest a methodological approach that can be used by analysts and practitioners to assess the factors increasing or ameliorating corruption during the privatization process and in its aftermath.

Initial Conditions: Post-Soviet Corruption and Spontaneous Privatization

We define corruption to be, simply, the abuse of official power for private gain. We circumscribe the meaning of private gain to significant financial payoff (or equivalence in kind), and do not address related issues of patronage. In the main, our definition encompasses two categories: the misappropriation of wealth for the benefit of a government official and the extraction of rents—whether in the form of bribes, kickbacks or special “favors”—from private entities.

The conditions prevailing in the FSU and CEE in the period immediately before and after the breakdown of the socialist system created an ideal medium for the growth of “monetary


12 Sometimes patronage is associated with direct financial rewards or their equivalent—and not just power—to the bureaucrat or politician. This particular patronage case is included in our narrower definition of corruption.
corruption. For many countries in the region, the origins of this situation reach back to czarist Russia, whose officials were generally considered to be pervasively corrupt at all levels.\textsuperscript{13} During the socialist era, the currency of corruption shifted, although not its prevalence, as the socialist central planners emphasized large-scale industrial investment at the expense of the production of consumer goods. This shift, together with the relative scarcity of cash and hard currency, limited opportunities for cash bribes.\textsuperscript{14} Instead, mid-level bureaucrats had to be content to vie for preferred access to scarce, low quality consumer goods and perks, such as access to dacha houses on the outskirts of the capital, better schools, vacations in sanatoriums and "study tours" abroad. Further, instead of cash corruption, many transactions were in the form of patronage for jobs in public enterprises and thereby related to political power and favoritism rather than large bribes or kickbacks. While patronage was rampant, blatant forms of corruption were somewhat held in check by the discipline of the Communist Party, draconian anti-bribery laws and the rigidity of the overall system itself.

At the outset of the transition, with the emergence of more cash, hard currency and Western consumer goods, the basis for more traditional forms of corruption was fully reestablished. At the same time, political chaos and the demise of the Party removed the main external constraints to rent-seeking behavior on the part of the managers of state enterprises and other government officials. Perestroika, with its encouragement of parallel, profit-oriented activities on the part of state-owned enterprises, had placed those enterprises on the path of independent profiteering at the expense of the state. The legal system was—and in many countries still is—often inadequate to address even elementary notions of private property ownership, individual commercial autonomy or the necessary limitations on the authority and

\textsuperscript{13} Robert K. Massie, in describing corruption in the Russia of Peter the Great, writes "Bribery and embezzlement were traditional in Russian public life, and public service was routinely looked upon as a means of gaining private profit. This practice was so accepted that Russian officials were paid little or no salary; it was taken for granted that they would make their living accepting bribes." Robert K. Massie, Peter the Great: His Life and World (New York: Alfred A. Knopf, 1980) p. 762.

\textsuperscript{14} In the FSU and CEE, to reduce corruption, a dual system of currency was developed, with bank credits used for most enterprise transactions and cash limited mainly to the payment of wages. See IMF, IBRD, OECD and EBRD, A Study of the Soviet Economy, Vol. 1(1991) pp. 10-11.
discretion of government officials. In those cases where appropriate legislation has been enacted, the means to enforce these new rules of law—courts, trained judges, lawyers and the entire legal infrastructure—is lacking.

The transition from the exploitation of power and access to goods and special perks to the unchecked appropriation of wealth for private use was facilitated by the previous regime's philosophical insistence that capitalism and the free market were lawless and corrupt at their core. Being thrust into the free market as inadvertent capitalists, many bureaucrats and citizens felt no cultural imperative to discourage the unbridled pursuit of wealth by any means.¹⁵

It was against this background that the issue of privatization arose. In fact, there was no considered decision to privatize by democratically weighing the pluses and minuses and carefully formulating an efficient strategy. The decision was thrust upon these new countries' leaders by the breakdown of the discipline of the old system and the absence of new institutions to replace it. Well before any formal privatization strategies were approved and implemented, a particularly corrupt form of "spontaneous privatization" was taking place informally through the blatant theft of state assets and diversion of revenues from state enterprises by their managers.¹⁶ The reformists in government, who understood that privatization was crucial to a successful transition to the market, saw early on the dangers of wholesale spontaneous privatization. They anticipated that such activities would give enormous political power to the old nomenklatura who opposed rapid reforms and enterprise restructuring, and they feared a popular political backlash would stall, if not reverse, the privatization process, or even reform itself.¹⁷

In the remaining sections of this article, we discuss, first, the factors that determined the privatization strategies now being employed in the FSU and CEE, and we provide a brief de-

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¹⁵ This was, after all, the essence of the capitalism about which they had been historically indoctrinated, dating to the writings of Marx and Engels.

¹⁶ This was as true in CEE as it was in the FSU. "A few years before the final collapse of the communist system, in countries such as Hungary, Poland and Russia, personal enrichment among Party ranks became a semi-official part of last-gasp "reform" policies pursued by the regime. The resulting scramble for riches came to be known as "spontaneous privatization." See Friedmann, Gray and Rapaczynski, p. 4.

¹⁷ This compelling reality provides the answer to the criticism offered by some observers that privatization in the FSU should have been delayed until a Western-style
scription of each strategy. We then identify the transactional characteristics that can be hypothesized to result in more or less corruption in the implementation of privatization strategies. An analysis of how various privatization strategies might contribute to less corruption in the post-privatization period is then presented. This is followed by a discussion of the incipient (and largely indirect) evidence of the general impact of privatization on corruption in the post-privatization environment. The final section summarizes and concludes, pointing to some practical implications of our work.

Privatization Strategies

As noted above, privatization was seen as a pragmatic struggle to restore order and legitimacy to a transition market, where the state bureaucrats and politicians would have less control over the enterprise sector. Once the inevitability of privatization was no longer in doubt, a number of subordinate goals were considered in shaping specific privatization programs. These objectives—which often were not attained—included maximizing government revenues, attracting domestic and foreign capital investment, promoting enterprise restructuring to increase efficiency, distributing wealth in an equitable fashion and building a constituency for continued reform.

There were numerous constraints on the achievement of these often conflicting goals. Political constraints included the need to purchase the support of powerful special interest groups, like the agrarians, enterprise managers, workers collectives and trade unions. In the early stages, it was also considered unacceptable in many countries, particularly in the FSU, to embrace privatization strategies that resulted in the transfer of the state’s wealth—the “national patrimony”—to foreigners. Financial constraints included a lack of resources: for government, which needed funds to purchase technical assistance and implement

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legal system with strong fiduciary controls had been put into place to limit corruption. For the FSU delay was not an available option. It was not just a matter of passing appropriate laws: without effective detection and enforcement mechanisms, legislation on the books is law in name only. To have waited until this entire system was functioning was unthinkable—there would have been nothing of value left to privatize. See Frydman et al. and Malia.
expensive privatization procedures, and for the population at large, which did not have the liquid capital to purchase privatized assets. Technical constraints abounded, including the absence of market-based financial and business skills and watchdog institutions for the new "free" market—such as accountants, rating agencies and financial market regulators—as well as the existence of undeveloped financial markets and inappropriate legal systems.

This multitude of goals and constraints, combined with differing local conditions, the pressures of economic collapse and a volatile political situation, could not have been expected to produce an "optimal" privatization strategy; indeed, it did not. Trade-offs ruled the decision-making process and in virtually every case a multi-track privatization strategy was implemented.\textsuperscript{18}

The element most common to these strategies was voucher-based mass privatization, in which governments gave away or sold vouchers for a nominal price to the general population. These vouchers are used to purchase shares in a multitude of companies. In most cases, voucher funds serve as either optional or mandatory intermediaries between the voucher holders and the enterprises. Mass privatization, which has been or is being implemented as a core privatization strategy in every CEE and FSU country but Azerbaijan, Hungary, Germany and Macedonia, tries to respond to the imperatives of quick action, equity, the shortage of domestic capital and the need to build constituencies supporting reform.

Individually negotiated trade sales and international tenders are transactions in which controlling blocks of shares are sold to strategic investors in individually negotiated, case-by-case transactions.\textsuperscript{19} This approach was initially embraced by almost every

\textsuperscript{18} This paper does not discuss small-scale privatization, which was implemented throughout the FSU and CEE primarily through voucher auctions and sales or leases to existing owners. Small-scale privatization represents a very small proportion of a transition economy's productive potential; as these enterprises had little tangible value as assets beyond their access to business premises. That said, however, small-scale privatization still had significant political importance in building a political constituency for reform and in providing some inputs and access to business premises for start-up firms. See EBRD Transition Report (1995) and IBRD, "Eastern European Experience with Small-Scale Privatization," CFS Discussion Paper Series, no. 104, (1994). By facilitating entry and competition, small-scale privatization indirectly resulted in diminished rent-seeking from monopolistic control rights.

country, to maximize sale proceeds, attract new investment with access to new technology and maintain employment, following the precedents in Chile and the United Kingdom in the 1980s. While the availability of unlimited technical and financial resources from the Federal Republic of Germany allowed East Germany to implement this strategy successfully, only Estonia (and to a much more limited degree, Hungary) have been able to replicate that result. Poland and Romania have also continued to emphasize these types of transactions, with severely limited success. The second wave of privatization transactions, where residual interests in specific enterprises and hitherto reserved “strategic” enterprises are sold, largely falls into this category, with the use of cash-based sales and debt-equity exchanges. In the context of domestic trade sales, a variant increasingly used in Russia in recent times has been the “loans-for-shares” program. Its main feature is the transfer of control rights—and ultimately ownership in many cases—over blocks of shares held by the Russian government in return for credits by domestic banks to the budget.

Privatization through equity offerings on the domestic capital markets—known in some countries as initial public offerings (IPOs)—have also been attempted for many of the same reasons as the above case-by-case strategies, but have been severely limited by the capacity of the nascent local equity markets. They are also time-consuming and expensive to implement, requiring the collection and dissemination of sufficient information about the enterprise so that potential investors can make informed purchases decisions. IPOs figure predominantly in plans to privatize the residual equity interests in enterprises partially privatized in many mass privatization programs.

In management and employee buyouts (MEBOs), enterprises are sold or given away to insiders, often with payment accepted in the form of vouchers or deferred payment arrangements to address the problem of a lack of capital liquidity in the purchasers.20 MEBOs have been used most often in Croatia, Georgia, Hungary, Poland, Romania, Russia, Slovenia and Ukraine. MEBOs

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are seen as quick and easy to implement as well as popular politically in directly rewarding workers of the enterprise. Special payment arrangements, discounts, off-market enterprise valuations and assigning special, above-market valuations for management and worker vouchers have all commonly been used in MEBOs to benefit insider purchasers.

Two final forms of privatization—more inadvertent than intended—should also be mentioned. *Spontaneous privatization,* mentioned above and often referring to the transfer of assets by stealth to the managers of the enterprise and/or to high officials and politicians, continues to be a common route from state to private ownership in many of the transition economies. For obvious reasons, statistics are not available in this area, but it is quite possible that, at least in terms of the aggregate volume of the assets involved, spontaneous privatization overshadows most other methods. Finally, *liquidation,* in which insolvent enterprises are disassembled and systematically sold off as individual assets, has been a growing phenomenon in the transition economies. However, only Estonia seems to have embraced liquidation as a privatization strategy, albeit with excellent results to date.\(^2\) While liquidation does meet the goals of revenue generation and the equitable distribution of assets, as well as speed and simplicity, the associated connotations of enterprise "death" and fears of the political backlash from anticipated unemployment have prevented most countries from publicly embracing it.

*Corruption in the Implementation of Privatization Strategies*

While it is undeniable that, in the transition economies, an increase in corruption coincided with the process of privatization, it does not necessarily follow that this increase was actually caused by the privatization process. Privatization may, in fact, have been no more than a convenient vehicle for corrup-

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\(^2\) See Nellis for the results of the Estonian privatization program, including liquidations. Germany’s *Treasury* reports that a total of 3,718 enterprises were targeted for liquidation out of a total of 13,805 during that country’s firestorm of privatization from 1990 to 1994. During the six years ending September 1996, Poland targeted 1,457 SOEs for liquidation, completing the process in about a third of these cases thus far.
tion that was ongoing and unchecked at that time. Differing approaches to privatization incorporate different factors that can either stimulate or hinder the potential for government officials and their private sector counterparts to engage in corrupt practices.

An Analytical Framework

To analyze the various factors that may influence the level of corruption in privatization transactions, it is useful to keep in mind a simple analytical framework for the potential sources of corruption, applicable when initial property rights are poorly defined. This we have drawn from the work on contract theory and property rights by Grossman, Hart and Moore, and then applied by Boycko, Shleifer and Vishny in providing a rationale and a design for the mass privatization program in Russia.

In this framework, ownership rights to an asset—such as a firm’s real estate—fall into two categories: control rights and cash flow rights. Control rights comprise the rights to decide how to utilize such real estate, including whether or not to sell, mortgage or lease it. Cash flow rights, in contrast, are the rights to the benefits which flow from the use of such assets—such as revenues from selling the goods produced by the firm, rental or sales income from the property.

As Boycko, Shleifer and Vishny point out, a major source of inefficiency in the socialist economies was the fact that politicians and bureaucrats had control rights over specific state-owned assets, yet by and large did not possess (legal) cash flow rights from those same assets. Instead, cash flow rights were officially in the hands of the state treasury or, at times, with particular government officials, other than the politician or bureaucrat holding control rights. This misalignment of control rights and cash flow rights—inevitably associated with political control over eco-

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22 In any event, as discussed above, the countries facing the transition had little or no choice as to whether to privatize, while they had a variety of options as to how to privatize.

nomic activity—led to inefficient outcomes, since the political decision-maker’s incentive was not to maximize the firm’s profits (cash flow), in which they did not have a direct stake. Instead, the incentive was to achieve general political goals, maximize personal political clout, benefit narrow constituencies, earn perks and, not infrequently, line pockets.²⁴

From this framework, it can be hypothesized that, in a non-privatized economy where the self-interest of politicians and bureaucrats dominates and legal institutions are weak, corruption is correlated with: (1) the extent of control rights over economic activity exercised by politicians and bureaucrats, (2) the degree to which cash flow rights are misaligned with control rights and (3) the level of civil service professionalism and pay incentives, as well as the effectiveness of the monitoring, enforcement and penalty processes applied to those engaging in corrupt practices. During privatization, corrupt practices can persist through lingering (or newly acquired) control rights that permit politicians and bureaucrats to block or direct privatization transactions. Moreover, as we will see in the following section, in the post-privatization era when cash flow rights are legally out of the public sector, the level of corruption will be related most significantly to the degree that politicians and bureaucrats have retained control rights over economic activities.²⁵

The Exercise of Control Rights During the Privatization Process

Against the above background, we now review factors relevant to the privatization process itself, to identify those which may increase or reduce the prevalence and exercise of control rights by politicians and bureaucrats, which, in turn, is hypothesized to be associated with more or less corruption.

1. Speed. Improper payments and self-dealing take time to negotiate and arrange, even in a non-transparent environment. Where large numbers of objects pass through the privatization process quickly, there is less time to arrange corrupt transactions and less time to exercise control rights. In addition, speed cannot be achieved without reducing administrative discretion, discussed below, which is crucial to rent-seeking by public officials. In short,

²⁴ Boycko, Shleifer and Vishny.
²⁵ Thus, by definition, the politician’s and bureaucrat’s residual control rights over privatized enterprises equals the degree of misalignment between control rights and cash flow rights.
both acquiring and exercising control rights takes time, so speed conspires against acquiring control rights and dilutes the practical power of exercising those rights.

2. **Level of Administrative Discretion.** Administrative discretion is the essence of control rights. Every point in the process of privatization that requires an official signature operates as a potential toll gate for corruption. When the decision to grant the signature is subjective and discretionary, it is easier for the official to justify delay and requests for further information—the universal language of demands for improper facilitating payments.

In contrast, processes that take decisions out of government hands, such as through the specification of standard charter documents (e.g., Russian Federation), or requiring individual enterprises to define their own initial privatization plans (e.g., Poland and Slovenia), reduce administrative discretion. Where some official involvement is unavoidable, the use of simple, transparent and non-discretionary rules can have a similar impact in reducing control rights by corrupt officials. In Ukraine, for example, establishing enterprise valuations through the use of book value as of a fixed, past date eliminated a complicated, time-consuming valuation process that would have naturally attracted corruption.26

3. **Transparency; Access to Information.** Like other forms of illicit behavior, the translation of control rights into corrupt side payments is facilitated by secrecy and a lack of transparency. Any process or decision that is required to be open to public scrutiny acquires thousands, if not millions, of unpaid auditors. In the context of public privatization programs, three types of information are potentially important.

The first type of information relates to the process. By making the rules of the game public, the government dramatically reduces the ability of corrupt officials to collect rents by permitting exceptions and violations of legal standards. The second important type of information pertains to the valuation of enterprises being privatized. In contrast to information about the process, the valuation of enterprises is most important in case-

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26 Another useful generic approach in this regard is to provide that, in the absence of official action for a given period, a specified legal result automatically occurs without further action ("negative option" procedures). This strategy was employed quite effectively in the Russian corporatization process, the first stage in the mass privatization program.
by-case privatization strategies such as trade sales, MEBOs and IPOs. In most mass privatization programs, in contrast, outside observers would agree that enterprise-level information is scarce and extremely unreliable, primarily because Soviet-era accounting systems were designed to monitor central plan fulfillment and do not provide credible information relevant to profitability or asset values. Extracting rents through the politician’s exercise of control rights becomes easier when the real value of enterprises is not known publicly. The final, and possibly most critical, aspect of transparency is the availability of information on the results of privatization transactions. It is only through knowledge about results that third-party observers can assess whether something was amiss in the implementation of a transaction. Without knowledge of results, information about process and value have relatively little utility.

4. Independent Administration of the Program. Where the decision has been made to transfer ownership of enterprises slated for privatization to a new implementing agency—GKI in Russia, the Privatization Agency in Estonia or the Hungarian Privatization and State Holding Company, for example—it becomes more difficult (but far from impossible) to exploit old, corrupt relationships. This not only takes control rights out of the hands of the traditional, often entrenched politicians and bureaucrats, but it also sends a positive signal to participants that the game now has more transparent rules. The new, temporary government owners, however, must be seen as responsible for the privatization process but not responsible for the day-to-day business of the enterprises. If such an arrangement is extended too long, control rights begin to crystallize, and the opportunities that corrupted the old owners are likely to have a similarly corrosive impact on their successors.

Using a new, specialized agency to implement the process also makes it easier to put effective monitoring systems into place. Extreme—and successful—examples of this approach are Germany’s Treuhand and Estonia’s system of international tenders. Both approaches vested ownership of enterprises destined for privatization in a specialized agency with a limited life and purpose. In both cases, domestic and international specialists from outside the government bureaucracy were hired on a temporary basis and brought in to do the actual work of implementation, although government officials were still left in overall charge of the process and empowered to approve transaction
terms. This meant, first, that the negotiators were monitored by officials with little real power to direct specific negotiating concessions, and, second, those ultimately empowered to approve the terms of the transactions were isolated from close contact with the negotiations and thus less helpful to influence with improper payments. By bringing in an independent outsider layer that was given some control rights over the transaction process, control rights by old bureaucrats and politicians were diluted. Consequently, their ability to extract rents from the process and to illicitly appropriate cash flow rights from the enterprise assets were diminished.

Analysis of Effects of Typical Privatization Structures on Corruption

Having set forth hypotheses as to those factors in the privatization process that may facilitate or deter corruption through their impact on control rights, we now examine the most common generic methods of privatization and suggest whether they are likely to be associated with such factors in their implementation. Table 1 summarizes the analysis presented.

It should be emphasized at the outset that these potentially corruption-alleviating or enhancing factors are not static and do not exist in a vacuum. They interact, both positively and negatively, reinforcing and interfering with each other. Moreover, in no case is a privatization transaction strategy pure, in the sense that it can be characterized in the real world strictly along the abstract dimensions we describe. Further, actors in the real world's corruption drama are ingenious in developing new strategies to counteract reforms that policymakers place in their path. Even in corruption, entrepreneurship pays.

Based on our previous analysis, the transaction structures discussed below are presented in the order in which they present overall opportunities for corruption, with these having the lowest potential presented first.

1. Voucher-Based Mass Privatization. Voucher-based mass privatization auctions, probably the most widely used privatization method and the one responsible for the greatest number of legal ownership transfers, have, in theory, the lowest potential for severe corruption in their implementation. By their nature, individual auction transactions tend to be completed more quickly than other types of transactions, although the program itself can take a long time to get off the ground, as in Poland and
Table 1: Corruption Potential in Typical Privatization Transaction Structures*

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<th>Speed</th>
<th>Admin. Discretion</th>
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<td>Voucher-Based Mass Privatization</td>
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<td>Capital Market-Based Privatization</td>
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<td>Tenders and Trade Sales</td>
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<td>Management-Employee Buy-Out (MEBOs)</td>
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<tr>
<td>Spontaneous Privatization</td>
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* Note: "-" and "--" equal low and very low corruption potential, respectively.
"+" and "++" equal high and very high corruption potential, respectively.
Ukraine. In other cases, such as Latvia, concern for ensuring that companies succeed in the market after their privatization has resulted in an extensive enterprise preparation and restructuring process which has slowed the mass privatization program almost to a halt.

The volume of transactions processed requires detailed rules and procedures, which precludes much administrative discretion being applied to those individual enterprises going through the auction process. Of necessity, information about the process is widely available, although enterprise-level information is usually scarce, with information about results often disseminated in an uneven fashion. Voucher-based mass privatization programs are always administered by independent, specialized agencies. In short, while no process is immune from corruption, the typical voucher-based mass privatization program has more natural features to limit the ability of politicians and bureaucrats to exercise control rights during implementation than any other.

2. Liquidation. As noted above, liquidation has not often been a country's chosen privatization method. Liquidation procedures can be relatively quick in the absence of any need for corporatization, valuation, due diligence or the preparation of an enterprise-level privatization or business plan. Given the creation of a whole class of new asset owners, largely without historical corrupt relationships to call on, the speed involved hinders efforts of corrupt bureaucrats to exercise preexisting control rights. While there are administrative decisions to be made, principally in the up-front decision to liquidate and in the negotiation of price for lines of business and other bundled assets, these are much less significant than the complex decisions needed to negotiate a trade sale for example. Most sales are made in efficient and transparent cash auctions, where information about the process is rudimentary and should be naturally available, and company valuations are irrelevant. To the extent that the auc-

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27 Much greater discretion is, however, employed in the decision of which enterprises will become subject to the auction process and which will be exempted—the point in the process reputed by observers to be the object of the most corrupt activity.

28 Poland, however, in taking over two years on average to liquidate an enterprise, demonstrates that even this method can be burdened by bureaucratic procedures that effectively create control rights in implementation. Krzysztof Pater and Anita Ryn, "Transition in Poland-1996," paper delivered at the Central and Eastern European Privatization Network's 7th Annual Conference on Privatization (Dubrovnik, Croatia: December 1996).
tions are public, information about results, such as sale prices, is also available. The process of liquidation typically takes place outside the historic government ownership structure, either through the courts or in a specially created government agency. Because individual decisions to liquidate and most price negotiations are undertaken outside the government sphere, the issue of control rights is largely moot, and liquidation has the potential for being an extremely honest privatization method.

3. Initial Public Offerings. Although there were initially high hopes for using emerging capital markets to privatize industries in the transition economies, successful transactions using this method have also been rare. Not only has the capacity of the markets grown too slowly to accommodate many transactions, but the costs of preparation and the expertise needed have limited the use of the capital markets to a small number of the highest-quality, best-known enterprises.29

The sale of shares of enterprises to be privatized can easily be designed to minimize corruption. While the transactions can take considerable time to prepare, as a result of the need to gather information on which investors can make their investment decisions, administrative discretion is not great.30 As in other cases, there is always the question of determining which enterprises will become subject to the process, which is almost non-transparent and involves virtually unchecked administrative discretion. However, transparency in the formal process itself is almost total, as the pricing process takes place publicly. The administration of public stock offerings is out of the hands of the former government owners—given the expertise required for these transactions.31

29 Poland has produced the bulk of initial public equity offerings, yet only 28 firms have successfully been privatized with this approach. See Pater and Ryng. The extent to which insightful analysts of the privatization process predicted the failure of IPOs in Poland some time ago is telling. At a conference in February 1992, Andrew Berg wrote about the overall failings of IPOs, while Jeffrey Sachs, arguing against such a company-by-company approach, specifically stated that it would lead to charges of corruption with every deal. See Olivier J. Blanchard, Kenneth A. Froot and Jeffrey D. Sachs, eds., The Transition in Eastern Europe, Vol. 2 (Chicago: University of Chicago Press, 1994).

30 Assuming predetermined valuations are not imposed on the process.

31 Even if the ownership of enterprises destined for privatization by initial public offerings is not transferred to a new governmental owner, the new owners are not identified until after the transaction takes place, so politicians and bureaucrats have no subjects to approach for bribes. Thus it is difficult—although not impossible—to "fix" a public stock offering.

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4. Tenders and Trade Sales. Tenders and trade sales are not rapid methods of privatization unless either the number of enterprises involved is small (Estonia) or the resources deployed are enormous (Germany). Specific transactions are negotiated individually, which not only takes time but maximizes the administrative discretion involved. However, due to the technical expertise needed, they are often administered by a specialized agency that had no prior contact with the enterprises being sold. As noted above, staffing this specialized agency with expatriate experts on fixed-term consultancy contracts improves monitoring and transfers control rights away from politicians. The tender process requires information to be made public about the process itself and the enterprises on offer, and governments usually report on the results of transactions completed. Where public tenders are not involved, however, public access to information is restricted, providing the "dark place" where corrupt sales of control rights can be negotiated.

The positive and the negative effects on corruption from tenders and trade sales may roughly balance each other out on average—but the variation can be very large. Some variants of domestic trade sales, such as "loan-for-shares" schemes in Russia, appear to be associated with improper practices. Thus, the level of corruption likely to be found with these transactions is more a function of country-specific characteristics than the result of the inherent nature of the approach. For example, where natural monopolies or access to valuable natural resources are being sold, tremendous pressures can be generated to distort an otherwise transparent process and perpetuate monopolistic structures. By the same token, participation by foreign investors with substantial experience, sophisticated advisors and alternative uses for their


33 This appears to have been the case in the ongoing controversy over the privatization process employed in Russia's telecommunications sector. Recently, the government announced that it was dismissing a consortium of Western investment bankers that had been working on a $1 billion public offering of Rostelecom, the state-owned enterprise for long-distance communications in the country. Control is being passed to two Russian banks that are expected to act not only as advisors but as investors. There were indications in the press that these banks were closely involved in the financing of President Yeltsin's reelection campaign. Financial Times, 26 November 1996.
capital, can be expected to bring a greater degree of transparency to tender and trade sale transactions.\textsuperscript{34}

5. Management and Employee Buyouts. Considerations of equity, as well as the political necessity of enlisting the support of powerful enterprise managers, have made MEBOs a critically important aspect of virtually every privatization program. These transactions are typically entered into either through the exercise of a purchase option in a prior leasing arrangement covering the enterprise, or on an ad-hoc basis as an alternative privatization track. In Ukraine, which is typical in this regard, enterprise leasing started during the era of perestroika, with highly favorable transaction terms and buy-out options with terms often completely unspecified. Even where the terms of the option were set forth, it was clear that they represented an extremely attractive, below-market price opportunity for the lessees.

In the most common circumstances, MEBOs present all of the factors potentially conducive to highly corrupt implementation. They are slow, highly dependent on government discretion and often not regulated by objective or precise criteria.\textsuperscript{35} Moreover, there is usually little public information available about either the process of fixing buy-out terms or the terms themselves. Control rights in MEBO transactions are thus maximized.

6. Spontaneous Privatization. By its nature, the volume of assets privatized through spontaneous privatization cannot accurately be determined, although the common public perception is that it is enormous. Not surprisingly, spontaneous privatization does not score well on the factors identified as contributing to less corruption in the implementation of transactions. While individual thefts can be quick, the overall process takes place over as long a period as the fiduciary controls in the economy fail to function. It is totally non-transparent and, by definition, does not involve the administration or monitoring of independent gov-

\textsuperscript{34} While it would be naive to assume that all foreign investors are scrupulously honest, it nevertheless remains true that, by and large, successful long-term foreign investors tend to seek fair and transparent environments for their capital investments, where they are treated on a par with domestic investors. Where a specific investment is made possible only through a corrupt official's actions, additional business risks are introduced which can make the overall transaction much less attractive, particularly in the transition economies, where macroeconomic, political and other risks are already high.

\textsuperscript{35} MEBOs are not as slow as trade sales, tenders, or IPOs because insiders already have all the information they need to make a purchase decision.
ernment agencies. Spontaneous privatization represents, in fact, the very essence of corruption, being the outright theft of public assets by politicians and/or enterprise directors associated with the nomenklatura.

In summary, privatization is a political process, reflecting the art of the possible. While it is fortunate that voucher-based mass privatization, with its low potential for corruption, has been such a popular strategy, this fact is possibly outweighed by the popularity of the two most corruption-prone strategies, MEBOs and spontaneous privatization, together with special trade sale procedures which have often been employed for the privatization of especially valuable natural monopolies and natural resources. Had there been the political opportunity and the resources to employ the liquidation and IPO strategies more often, at the expense of non-transparent, corruption-prone alternatives, it is likely that overall corruption in the implementation of privatization program would have been reduced.

The Impact of Privatization Methods on the Post-Privatization Corruption Environment

A. Control Rights Outside Privatization Transactions: Licenses and Public Finance

Arguably even more important than the incidence of corruption in privatization transactions is the impact of privatization itself, and of different methods of privatization, on the general levels of corruption in the economy over the medium and the long term. What characteristics of the process of privatization contribute to an environment conducive to the longer-term result of less corruption? Cash flow rights, as well as most of the traditional control rights over enterprises are transferred away from the state through the privatization process itself. Thus, sources of future corruption depend largely upon the ability of politicians and bureaucrats to create new control rights or to redefine old control rights, the exercise of which can be sold to extract rents. The most important control rights remaining after privatization are: the right to grant government permission to engage in specified economic activity via licenses, approvals, consents and the like (collectively, "licenses") and the right to grant
access to public monies, whether directly through cash subsidies, indirectly through subsidized or preferential credits, or through tax exemptions (collectively, "public finance").

Access to both licenses and public finance are a source of revenue to a private firm, creating rents which can be extracted by politicians and bureaucrats selling their exercise of these control rights. In the post-privatization period, politicians and bureaucrats will naturally attempt to maximize the number and value of the remaining and newly-created control rights. This will involve them in adversarial relationships wherein private firms pay politicians and bureaucrats to exercise their control rights to exclude other firms from the market, creating additional rents through commercial monopolies and oligopolies for the benefit of the bribe-paying firm.

B. Determinants of Control Rights in the Post-Privatization Environment

It follows from the above that one must focus in the post-privatization environment on those factors that tend to strengthen or weaken government-held control rights that survive privatization, as well as the factors that advance or retard the formation or exploitation of collegial relationships between politicians and bureaucrats and their private-sector clients. To the extent that either the control rights are eliminated or preexisting collegial connections are severed, there will be more competition among private enterprises, resulting in fewer and less valuable rents, and a slower formation of new rent-seeking arrangements by politicians and bureaucrats attempting to replace the old control rights from the socialist era. From this perspective, a number of factors inherent in typical privatization strategies appear to be relevant, as summarized in Table 2.

1. Residual State Ownership. (a) Program Scope. Most governments came to the decision to embrace privatization reluctantly and with far less than political unanimity supporting their decision. The need to establish a political consensus, combined with uncertainty over the proper scope of the program and the future of some politically sensitive sectors, such as agriculture, have combined to exclude major portions of the economy from the early

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<table>
<thead>
<tr>
<th>Management-Employee Buy-Out (MEBOs)</th>
<th>Spontaneous Privatization</th>
<th>Tenders and Trade Sales</th>
<th>Initial Public Offerings</th>
<th>Voucher-Based Mass Privatization</th>
<th>Liquidation</th>
</tr>
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<td>-</td>
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</table>

Note: "-" and "+" equal low and very low corruption potential, respectively. "++" and "+++" equal high and very high corruption potential, respectively.

Table 2: The Impact of Privatization Structures on Corruption in the Post-Privatization Environment.
stage of the privatization process. Even today, almost seven years after the first privatization began, few countries can approach the record of Slovenia, which had 90 percent of its medium and large enterprises in the privatization process by the end of 1994, or the Czech Republic, which abolished its Ministry of Privatization in mid-1996. Over time, as the reform process wears on, the programs will be extended, but, while that occurs, the emergence of a strong competitive lobby to reduce control rights by politicians and bureaucrats will be impaired, and opportunities for establishing and reinforcing close ties between state managers and governmental officials in support of monopolistic and corrupt practices will endure.\footnote{Frydman, Murphy and Rapaczynski describe what can happen when even more successful privatization programs slow down while a substantial portion of assets remain in state hands: "Until recently, the Polish ex-communists had their hands tied by the aggressive presidency of Lech Walesa. They could not therefore attempt any radical moves, but they were ruthless in placing their henchmen on the boards of state companies, staffing local governments with their supporters, and distributing patronage positions among allies. They stalled as long as they could the moribund mass privatization program and attempted to emasculate its anti-nomenklatura elements by insisting that privatization fund managers have personal experience in running state enterprises." See Frydman et al., p. 7.}

(b) Residual Government Ownership in Partially Privatized Companies. Often, privatization programs target less than 100 percent of an enterprise's shares for privatization in first round transactions. In most of the mass privatization programs, for example, some shares have been withheld to be used in subsequent voucher auctions, for restitution to former owners or for future sale to strategic investors. In Poland, Slovenia and the Czech Republic, among others, shares that could not be sold on the capital markets remain, as well as shares that secure deferred payment obligations of strategic buyers. Regardless of the circumstances, maintaining a partial ownership link with the government sustains the government official's direct control rights, with the special opportunities for rent-seeking that this implies. Where the government retains exceptional governance powers, such as through the use of so-called "golden shares," this risk—and the potential for corruption—increases. In addition, these residual ownership links create a built-in opportunity for privileged access by partially privatized firms to politicians and bureaucrats that are designers...
of control rights over licenses and public finance.

2. Residual Purchase Obligations. A great many of the case-by-case privatization structures, including international tenders and trade sales in particular, involve post-privatization covenants by the purchaser to maintain certain levels of employment and/or to make specified investments in the privatized enterprise. The German Treuhand program and Estonia’s international tender program made extensive use of such covenants in lieu of a portion of the cash purchase price. From the government’s perspective, these may make political sense where the goals of privatization are to stimulate investment and to preserve employment. Nevertheless, they involve the government intimately in the future business of the enterprise and give politicians and bureaucrats additional control rights that may be discretionary and open to abuse.

3. “New” Owners. Where privatization results in the transfer of control and cash flow rights to independent parties having no preexisting relationship with the old government owners, the re-establishment of corrupt relationships should be more difficult. Almost by definition, the identification of such “new” owners carries with it some heightened degree of personal commitment to the efficient management of a privatized enterprise, since the new owner has been willing to put capital at risk in the venture. Where a privatization transaction results in a cadre of new and competitive owners, those owners can be expected to become a constituency for the deregulation and liberalization of the economy, as well as for macroeconomic stabilization, in light of the significant costs imposed on private business by the absence of either. Here the hoped-for dilution of state control rights would not happen so much through the elimination of such rights, but more indirectly through political pressures to reduce the ability of politicians and bureaucrats to control licenses and access to public finance.

4. Corruption in the Implementation of Privatization Transactions. On the theory that corruption begets corruption, as old-guard economic actors are reinforced in their beliefs that the old techniques still work, those methods of privatization prone to be corrupt in their implementation should be associated with higher levels of corruption in the post-privatization environment. Further, where privatization transactions have been corrupted to
preserve or give rise to powerful monopoly positions, the new owners are more likely to be able to influence politicians and bureaucrats to provide subsidized resources and further market protection. In such cases, control rights by politicians and bureaucrats over the enterprise sector may actually increase as a result of particular privatization structures.

C. Analysis of Specific Transaction Structures

Liquidation, once again, emerges as a favored approach from the standpoint of reducing long-term corruption, as a result of its thorough reshuffling of asset ownership and the severing of control rights that implies. The retention of residual state equity interests is not possible; nor, as a practical matter, is the imposition of post-privatization investment or employment covenants. The purchasers are mostly “new” and largely not, by virtue of the privatization process itself, connected with the previous holders of control rights. The one significant liability of liquidations as a privatization methods is that, as noted above, it has been employed in a very limited fashion thus far, without much potential for the far-reaching divestiture of control rights from politicians and bureaucrats.37

Voucher-based mass privatization also presents a positive opportunity, overall, for a reduction of corruption in the post-privatization era, as do IPOs. They both have relatively low susceptibility to corruption in their implementation and are poor vehicles for the imposition of long-term, post-privatization obligations for the state.38 The major distinguishing advantage of voucher-based mass privatization is its efficiency, which gives it potential for a broad scope. The major disadvantages of both mass privatization and IPOs lie in the ease with which the government can hold back residual equity interests for later sale, with the lingering opportunities for exercising control rights in the future that this connotes. This connection is particularly

37 In the future, however, this may change as governments face the prospects of privatizing the large group of unprofitable "dinosaurs" left in the military and heavy industrial sectors.

38 All three methods can also serve to establish new ownership relationships, although, as the Russian mass privatization program demonstrates, the granting of bidding preferences to workers and management can undermine the best possibilities of this methodology.
troubling where a broad dispersion of public ownership effectively enhances the corporate governance (control rights) potential of even relatively small residual holdings.

Tenders and trade sales, as well as spontaneous privatization, fall into a similar category. With the exception of some types of domestic tenders, they effectively sever links to the old ownership structure with new strategic investors, yet they are highly susceptible to corruption in implementation. Tenders and trade sales quite commonly involve residual obligations to the state relating to future investments, employment levels and even maintaining specific lines of business. Spontaneous privatization, by definition, does not involve this, but neither does it truly sever old ownership relations by bringing in new owners. To the extent that spontaneous privatization is conducted with the connivance of government officials, moreover, it actually may reinforce those old relationships (partners in evil), and it may impede entry and competition in the medium term, perpetuating inefficient and corrupt monopolistic structures.

Finally, MEBOs are, at least in theory, most likely to be associated with higher levels of future corruption. While they do not often involve residual government ownership, various deferred payment obligations often reinforce the old ties to government. In addition, residual legal commitments are commonplace, the owners are, by definition, not "new" and the susceptibility of MEBOs to corruption in implementation is great.

As we conclude that, for levels of corruption in the long run, different methods of privatization have different impacts, we once again have to recognize that the relationship is not unidimensional. Even the broadest, most complete and most honest privatization program that creates motivated new private owners will not itself guarantee a significant and enduring reduction in licensing- and public finance-related control rights. This is because the "bottom-up" pressures from the new constituency for liberalization and related reforms, such as stabilization, cannot induce change without a parallel, top-down commitment from the political leadership to implement such reforms. The major pillars of reform—stabilization, liberalization and privatization—are mutually reinforcing; causality does not run solely from privatization to the other reform components. This is relevant for economy-wide corruption in the post-privatization environ-
ment, since a substantial share of rent-seeking activities stems from unstable macroeconomic conditions and illiberal markets. Thus privatization alone cannot be relied upon to eliminate rent-seeking. It is to the role of privatization in this larger context that we turn in the following empirical section.

**The Impact of Privatization on Corruption Generally: A Preliminary Look at the Evidence**

How has privatization fared within this overall rent-seeking framework for transition economies? On balance, would it be expected to increase, be neutral or decrease corruption for the economy as a whole in the post-privatization era? First, we examine separately the two common objectives of rent-seeking behavior: access to public finance and licenses.

**Privatization and Public Finance**

Most countries experienced severe macroeconomic instability as they moved into the first stages of the transition, accompanied by very high inflation; some, like Georgia, Ukraine, Belarus and Armenia, experienced hyperinflation. This severe macro-instability can be traced to the impact of self-defeating fiscal and monetary strategies flowing from the undisciplined practices learned—even rewarded—under the prior socialist system. Actions taken in response to the large initial shocks experienced by these economies when their traditional trade relations were disrupted virtually guaranteed instability and inflation in the new, more open economic system. This lack of discipline was reflected in very large subsidies, tax exemptions and soft credits that flowed to politically powerful subsectors and large enterprises. The

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40 While there is a symmetry between tax exemptions and subsidies, there are two important differences as well. Subsidies are unbounded, except by the state’s ability
new vacuum of fiduciary controls, flowing both from the absence of party discipline and the lack of legal constraints and enforcement capabilities, often led to private enrichment.

Da Cunha and Easterly analyze the flows of financing from government to the enterprise sector in Russia in 1992-93 and find staggeringly high amounts of resources that went to selected enterprises and financial conglomerates. During 1992, credit emissions in Russia totaled 33 percent of GDP, mostly in highly subsidized terms. The bulk of these credits had nominal interest rates of 10-25 percent, at a time when inflation exceeded 1,000 percent, making them essentially self-liquidating grants. Through these credits and subsidies, massive rent-seeking took place by those officials who approved the transfer of resources. To add insult to injury, a significant share of the transfers to enterprises appears to have ended up as capital flight to Western banks. These credits and subsidies were financed by a huge inflation tax, which had significant negative distributional consequences, as it fell disproportionately on households and on those enterprises that did not have sufficient political power to give them access to the flows of public finance.

For the reformers, it was recognized early that breaking the old patterns of economic behavior was possible only through the depoliticization of the allocation of resources. Depoliticization, therefore became a key objective for privatization in Russia and other countries in similar situations. The hope was that privatization would break the old ownership links from business to government, impairing the ability of enterprise directors to influence politicians and officials—the key to their virtually unlimited access to inflationary credits and subsidies. For Russia, the subsequent early evidence does indicate that depoliticization had at least some such impact, as a massive privatization program has been, at the very least, associated with a substantial reduc-

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42 Aslund et. al.
43 Da Cunha and Easterly.
tion of preferential subsidies and credits. By the mid-1990s, when Russia had privatized the majority of its enterprises, it also had macroeconomic stability within its grasp.  

At the same time, there is emerging evidence from a broad range of 25 transition economies of a significant association between a higher share of the private sector in the economy, on the one hand, and reduced inflation rates, on the other. While far from conclusive regarding causality, the data at least suggests that the depoliticization resulting from privatization diminished rent-seeking behavior by sharply reducing two important objects of that behavior: inflationary subsidies and soft credits. Further evidence at the firm level is provided in an empirical study on Russia in 1994, which shows state enterprises benefiting more from preferential loans than either privatized or new private firms.

In the competition for subsidies, a lower absolute volume of subsidy payments automatically results in a lower volume of bribes, with an associated decrease in corruption. In terms of the rent-seeking framework discussed above, privatization put downward pressure on the overall incidence of corruption in the economy by reducing the supply of public finance controlled by branch and sectoral ministry officials—the traditional objects of rent-seeking.

**Privatization and Licensing Powers**

The second way in which privatization can reduce rent-seeking lies in its effects on the trade, exchange rate and pricing regimes. Privatization can create political pressures to reduce the volume of license-granting powers retained by the state, thereby reducing demand for such licenses and, thus, the rents payable for them. As privatization proceeds, accompanied by the entry of new firms into the economy, both the diversity and the number of economic agents increases. While the opportunities for bribe-taking increase in absolute terms with so many new

45 Aslund et al., Figure 6.
46 John S. Earle, Saul Estrin and Larisa L. Leshchenko, “Ownership Structures, Patterns of Control and Enterprise Behavior in Russia,” mimeograph, (Budapest: Central European University, 1995):
47 No rational bribe-payer is going to pay more for a subsidy than the amount of the subsidy itself.
private players, public officials become increasingly overstretched; their ineffectiveness and rent-seeking behavior become increasingly apparent, while the new private sector players become better organized. They form political lobbies that influence government to put into place a more pro-business policy environment, thereby lowering the overall cost of doing business.  

Again, while far from conclusive at this early stage in the transition, the evidence is at least suggestive of an association between privatization and diminished rent-seeking through a reduced volume of licenses. First, the multi-country evidence from the analysis in Aslund, Boone and Johnson points to a highly positive relationship between the share of the private sector in the economy and liberalization during the transition. Second, the firm-level evidence from the enterprise sector in Russia in Earle, Estrin and Leshchenko suggests that privatized enterprises were more successful in divesting themselves from government controls than state enterprises. Third, the evidence presented below correlating the extent of privatization with the evolution of the unofficial economy suggests that those countries that privatized rapidly experienced less of an increase in their unofficial economies.

Table 3 suggests the existence of an empirical relationship between medium- and large-scale privatization (measured by the index for large-scale privatization progress constructed by EBRD for their transition report) and the evolution of the unofficial economy, using the estimates for sixteen countries. Further, Table 4 suggests a similar trend when comparing overall privatization and private sector development (PSD) in a country (through an index of privatization and PSD constructed by the World Bank for their 1996 World Development Report) with the evolution of the unofficial economy. Regardless of whether a privatization index or a privatization/PSD index is used, the differences in both

48 This generalization does not apply universally, however. Large, privatized conglomerates and powerful new entrants into particular sectors, in association with public officials, can perpetuate or even intensify monopolistic, anti-liberalization tendencies. The evidence from the emerging financial industrial groups in Russia and in selected energy subsectors in some FSU economies is illustrative. Yet over time even some of these groups may become converts to reforms—if they are in potentially growing industries, since through reforms they expect the value of their holdings to increase. See Karlova (1996) pp. 11-13.

49 Kaufmann and Kaliberda, 1996

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Table 3: Medium/Large Scale Privatization and the Evolution of Unofficial Economy in 16 FSU/CEE Countries

<table>
<thead>
<tr>
<th>Large Scale Privatization Progress</th>
<th>Large Scale Privatization Progress Score (EBRD)</th>
<th>Unofficial Economy Change in Share: 1989-1994 (% of points increase)</th>
<th>Unofficial Economy Share end-1994 (% of overall economy)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Little Privatization</td>
<td>1 or 2</td>
<td>23%</td>
<td>38%</td>
</tr>
<tr>
<td>Medium Privatization</td>
<td>3</td>
<td>14%</td>
<td>27%</td>
</tr>
<tr>
<td>Substantial Privatization</td>
<td>4</td>
<td>8%</td>
<td>23%</td>
</tr>
<tr>
<td>Average</td>
<td>2.6</td>
<td>17%</td>
<td>32%</td>
</tr>
</tbody>
</table>

Sources: Medium/Large Scale Privatization Progress Index, ranging from 1 (no progress) to 4 (very substantial progress) from EBRD (1995). Unofficial economy share estimates from Kaufmann and Kaliberda (1996), defined as percent of unofficial economy in overall GDP.

Table 4: Privatization/PSD (PRIVI) Index and the Evolution of the Unofficial Economy in 16 CEE/FSU Countries

<table>
<thead>
<tr>
<th>PRIVI Index (0-100)</th>
<th>PRIVI Index average for range</th>
<th>Unofficial Economy Change in Share: 1989-1994 (% of points increase)</th>
<th>Unofficial Economy Share end-1994 (% of overall economy)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0&lt;PRIVI&lt;20</td>
<td>15</td>
<td>32%</td>
<td>44%</td>
</tr>
<tr>
<td>20&lt;PRIVI&lt;40</td>
<td>28</td>
<td>13%</td>
<td>28%</td>
</tr>
<tr>
<td>40&lt;PRIVI&lt;100</td>
<td>57</td>
<td>4%</td>
<td>20%</td>
</tr>
<tr>
<td>Overall Average</td>
<td>29</td>
<td>17%</td>
<td>32%</td>
</tr>
</tbody>
</table>

Sources: PRIVI index standardized from Denizer, Gelb, De Melo and Gelb (1996) for range from 0 (no progress) to 100 (maximum). Unofficial economy share estimates from Kaufmann and Kaliberda (1996).
the size and change of the unofficial economy between transition countries that privatized much as compared to those that privatized little are very large.

Finally, the micro-evidence from the survey of 200 firms in Ukraine and Russia also suggests a relationship between the size of the unofficial economy and corruption: total extra-legal payments (bribes, facilitation payments, etc.) comprise one percent of turnover for those enterprises that underreport their activities only a little, while those underreporting significantly have to pay significantly more, about eight percent of their turnover. A link appears to exist between the degree of participation in the unofficial economy and the volume of corrupt payments, since firms essentially must pay officials to underreport.

The evidence also appears to be consistent with the proposition that privatization can encourage the formation of a novel political alliance between new owners, now possessed of much of the economic power formerly belonging to the state, and reforming politicians, who, in pursuit of greater economic output, desire to eliminate barriers to the realization of a functioning private sector. Thus, privatization, by becoming a contributing factor to depoliticization, can reduce the extent of control rights held by politicians and bureaucrats. It should be noted, however, that even the incipient empirical evidence at our disposal suggests significant cross-country variation.

Our data is unlikely to capture the negative impact of some large corrupt monopolistic transactions. Further, specific country conditions (such as the tradition and professionalism of the civil service sector and the enforcement of the rule of law), as well as approaches to privatization are bound to have an impact on the type, if any, of corruption-reduction taking place. Moreover, the political picture is far more complex in reality than suggested by average trends or polls, since the forces of conservatism are strong in these countries, particularly in the often contentious relations between the central government and local municipalities, which have their own, often anti-reform agendas. It is only as these centrifugal political forces are resolved in the transition that the reform constituency created by privatization will have its maximum impact.

In the next survey-based section we move from the general to the specific and consider whether there may be differences among different privatization structures in respect of how they
Figure 1:
The Privatization Process and Impact on Corruption

(Average for the Sample of 16 Countries FSU/CEE)
influence the level of corruption in the post-privatization environment.

An Informal Survey of Experts on Privatization-Corruption Links

Under our framework of analysis, we hypothesized that privatization can foster the growth of a new private sector reform constituency, bringing pressures to bear for a more competitive and fiscally disciplined environment. This, in turn, is expected to be associated with reduced opportunities for corruption in the economy. While the data presented above supports these hypotheses, its level of aggregation and indirect nature indicate that it cannot be conclusive or reveal more about the nexus between privatization and corruption from an empirical standpoint.

Hence, we embarked on an informal survey of privatization experts in transition countries. We asked over 50 of these experts from the World Bank, academia and the countries themselves, 10 questions on privatization "inputs" (speed, quality of information at various stages of the privatization transaction and administrative discretion), as well as on privatization "outputs," as far as the corruption nexus was concerned (reputation of privatization in terms of corruption; incidence of corruption in privatization transactions compared with other transactions; impact of privatization on overall post-privatization corruption in the country, and post-privatization incidence of corruption in privatized vs. non-privatized sectors.) We tabulated and aggregated for each country the responses on a scale of one to five for each question, one signifying a maximum positive score (whether high speed of privatization as an "input," or no corruption whatsoever as an "output") and five signifying the worst possible score. The results are telling on a number of dimensions, which are summarized for all countries for which we received at least two expert responses (16 such countries in the FSU/CEE) in Figure 1.50

The conclusions that emerge from this initial survey evidence are, first, that the lack of speed and level of administrative

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50 Caveats apply to this empirical approach; given the subjective nature of the responses; the precise numbers ought not be subject to over-interpretation.
discretion in privatization programs are seen as more conducive to corruption, while the quality of available information is seen as less conducive to corruption; second, on average, the process of privatization is perceived as substantially corrupt in terms of its overall reputation. In contrast, the assessment by experts regarding the relative incidence of corruption during the privatization process and the post-privatization environment is significantly less negative. In particular, privatization transactions appear to be less corrupt than transactions in the rest of the economy, and privatization programs may have somewhat helped ameliorate the incidence of corruption in the post-privatization era as compared with a non-privatized past. Finally, corruption in privatized sectors of the economy is significantly less than in non-privatized sectors. These conclusions are consistent with the hypotheses outlined earlier in this paper.  

**Conclusions**

The formalization of privatization as a reform strategy was forced on the transition economies by the simple fact that social, political and legal/fiduciary controls had collapsed in the wake of the Soviet Union's break-up. The theft of assets effectively started, in fact, a few years before communism fell. Following the break-up, the state's assets were being stolen by enterprise managers, politicians and bureaucrats at an intolerable rate and, for most countries, the only alternative to sanctioning wholesale theft was to make the process somewhat more transparent and participatory and to try and direct these assets to other hands in pursuit of socially and economically more positive goals.

This paper has analyzed how different privatization paths, whether formalized or not, may have affected the incidence of corruption. The analytical framework used to drive the discussion of the specific factors at play in this link draws from the

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51 A comparison of the survey results between different areas in the region indicates that: (1) the quality of information available in the privatization process is perceived to be much higher in countries in CEE than in the FSU; (2) privatization is perceived to have a strong corruption-reducing impact in CEE for the medium term, while neutral overall in the FSU (including the Baltic countries); and (3) only in the Baltics is the reputation of the privatization process for corruption seen as even neutral—elsewhere in the region, the process' reputation is highly negative. For the other overall results reported above, no large intra-regional differences appear to be present.
contract theory and property rights literature. Given the weaknesses in the system of legal and cultural fiduciary controls, we posited that, during the transition, corruption will be related to the scope of control rights over economic activity in the hands of politicians and bureaucrats. When the rights to cash flows from privatized assets can be impaired through the exercise of control rights in the hands of politicians and bureaucrats, the opportunity for extracting rents through the collection of bribes arises.

This control rights framework was then applied to a detailed discussion of the link between privatization and corruption during the unprecedented transition that these countries have faced. This necessitated distinguishing between two situations. We first reviewed what impact different privatization strategies had on control rights of politicians and bureaucrats over privatization transactions as a direct source of corruption. We then analyzed the impact of privatization on post-privatization economy-wide corruption, assessing what control rights were diminished or enhanced by different approaches to privatization. In this second situation, in addition to government control rights that continue to exist in relation to specific enterprises (corporate governance), we assessed what impact privatization has on government control rights over public finances and licenses sought after by all private enterprises.

From this framework, a number of specific factors emerge in each of these two situations. Where privatization program implementation is the focus, the following were emphasized: speed, the level of administrative discretion employed, transparency and access to information, and whether or not the program is administered by a government agency differing from the one which previously owned the assets in question. Applying these factors to the most common methods of privatization generally points to voucher-based mass privatization and liquidation as the least corruption-prone implementation methods. These two methods share advantages on all relevant dimensions. In contrast, management-employee buyouts and spontaneous privatization are highly conducive to corruption in their implementation, principally due to their slow pace, high levels of discretion and lack of transparency. Initial public offerings and tenders and trade sales fall between the two extremes, with the disadvantages of slow speed of implementation balanced against the advantages of transparency and independent administration.

The same framework was then applied to as post-transac-
tion corruption stemming from different privatization structures. In this case, first in terms of control rights over enterprise governance, we suggested that liquidation, with its reshuffling of the ownership links and complete severing of residual state connections, is the most favored method, followed by voucher-based mass privatization and initial public offerings. The latter two methods suffer from the common failure to sell the state's entire interest at one time. Tenders and trade sales would score far better, but for the common practice of applying residual legal obligations for the state to monitor and enforce over time. Ignoring its obvious ethical failings, spontaneous privatization evaluates relatively well on a number of criteria (relevant for post-privatization), with the dramatic—and significant—exception of the fundamental corruption evident in its very existence, as well as the incidence of lingering obligations to politicians and bureaucrats which many spontaneously-privatized enterprises inherit as the price of official tolerance.\(^{52}\) Finally, management-employee buyouts are seen as the most conducive to long-term corruption—a high price to pay for purchasing the political support of corporate insiders for the reform process.

Perhaps the single most important conclusion that emerges is that, from a corruption standpoint, taking into considerations all other characteristics of the transition, privatization—with all its inadequacies—is preferable to its absence. While the survey of experts we carried out suggests that overall privatization does not have a good reputation in the FSU and CEE, these same experts point out that the incidence of corruption is, or would be, larger without privatization, and that corruption is more prevalent in non-privatized sectors. Similarly, we presented complementary evidence which is at least suggestive in terms of extralegal and unofficial activities being more prevalent in the FSU and CEE settings that have privatized less. There is an incipient body of evidence pointing to a positive association between privatization

\(^{52}\) This does not imply that the "end" of lower corruption can justify the "means" of such fundamental and widespread illegality. Yet the possible historical irony remains that some of the progress—social, as well as economic—which will come from privatization and structural reform might ultimately be traced to the simple, unstoppable theft of state assets and the resulting political imperative. In the longer term, however, a crucial characteristic of spontaneous privatization will be whether it took place within a competitive industry, or whether it perpetuated or created large monopolistic structures (as in the case of some energy and telecommunications subsectors in the FSU).
and some hardening of the budget constraint (for example, less discretionary public handouts or tax exemptions), as well as between privatization and market liberalization (such as less discretionary licenses in the hands of politicians and bureaucrats). Since the reduction of control rights by politicians and bureaucrats over public finance and licenses to enterprises are key for the reduction of corruption, this evidence is consistent with the analytical framework we have presented.

What are the practical implications of our analysis? First, the notion that transition economies are already fully in the post-privatization stage needs to be revisited; privatization in the transition economies, while unprecedented in its scope so far, is far from over. Given the magnitude of the holdings that still remain in the hands of the state, a faster and simpler second stage of privatization initiatives and programs ought to be implemented. Where politically feasible, recapturing the daring early days of mass privatization programs in some countries may be warranted. Suitably adapted with the lessons learned, speedy privatization of remaining state interests is likely to reap substantial benefits compared with the alternatives. In this context, the outright cancellation of residual state ownership in partially privatized enterprises could be considered as well.

Our framework of government control rights and depoliticization does not suggest any kinder dispensation for sectors other than the enterprise sector, not yet subject to serious privatization efforts. To the contrary, in some countries in the region corruption has in large part been fueled by the lack of privatization in agriculture and in parts of the energy sector, where the old nomenklatura has continued to benefit from large handouts, kickback, and huge monopoly rents. Excessive gradualism, coupled with the vested interests of the old nomenklatura in this area, have extracted a heavy toll for these economies—especially, in terms of corruption. Thus, a much bolder—and transparent—approach to privatize land, agricultural and energy assets is needed, such as that seen in the case of agriculture in Armenia and Albania early in the transition.53

When deciding to continue—or embark—on a bolder privatization program to complete the process, how should the next phases be designed to minimize the potential for corrup-

53 The former effectively privatized all land before legions of advisers came to the FSU to advise, and the latter did it later, but overnight—literally by the stroke of a pen.
tion? Experience in the first five years of privatization indicates that speedy mass privatization techniques, resulting in full transfer of the interests sold, without special deals for insiders and without attaching lingering investment or employment obligations, should be the goal in designing strategies for the next phase of privatization. For those enterprises in the worst shape financially, liquidation should be the preferred alternative. Open and competitive international tenders and trade sales should be reserved only for the most obviously attractive candidates, where international interest is likely, while MEBOs should be avoided. Branch ministries and other ex-owners should be excluded from the process, to sever the old control rights relationships, and replaced by specialized agencies supplemented with expatriate technical assistance, where available.34

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The final words on privatization in the reform of the post-socialist economies will, as always, be written by the historians. Our contribution to this debate, made while the storm of the transition is still raging, is that in evaluating privatization overall counterfactuals are critical, as is the necessity of taking the long view. Even in its relatively corrupt incarnations, privatization is likely to contribute positively to the long-term movement from a bankrupt and essentially corrupt economic system to a freer and more democratic one. Equally important, within the scope of available approaches, some more transparent and competitive privatization methods can set the stage for a reduction of corruption in the future. We have, in this paper, hypothesized some of these connections. The next step will be to subject these hypotheses to further empirical analysis, confirming or challenging the initial conclusions which flow from our analysis and the early information available. ▲

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34 Privatization per se will not suffice, of course, in addressing corruption. Improved entry of private enterprises and significant deregulation over economic activity will also be needed, as well as a revamping of government institutions and of the civil service in a number of countries. Privatization is expected to sever only some types of politicians’ and bureaucrats’ control rights. In this context it will be important to de-monopolize and open the door the international competition when privatizing large monopolies in transport, energy and communications.

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