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The Politics of Privatization: Wealth and Power in Postcommunist Europe

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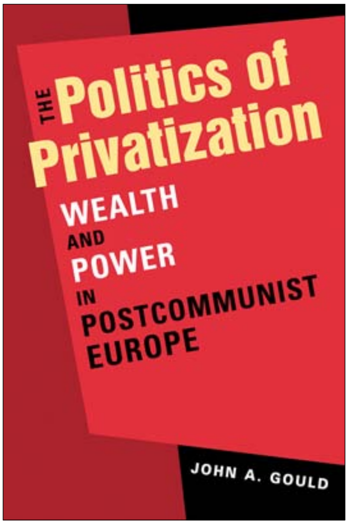

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Introduction

The violence and injustice of the rulers of mankind is an ancient evil, for which, I am afraid, the nature of human affairs can scarce admit of a remedy. But the mean rapacity, the monopolizing spirit of merchants and manufacturers, who neither are, nor ought to be, the rulers of mankind, though it cannot perhaps be corrected may very easily be prevented from disturbing the tranquillity of anybody but themselves.
—*Adam Smith,* Wealth of Nations

Privatization, or the transfer of economic assets from state to private hands, is based on the usually justified assumption that private owners will appoint better managers than governments. When communism fell in Central and Eastern Europe in 1989, there was a clear need for privatization. Europe's communist governments had nationalized most of their countries' economic assets. In Czechoslovakia, for example, state-owned enterprises accounted for virtually all official economic activity. Many of these firms suffered from poor state planning and perverse market controls; some firms produced products that were worth less than the combined cost of labor, energy, and materials that went into their production. In addition, state ministers, managers, and employees excelled at expropriating enterprise resources for their own use. Such theft aggravated the firms' crises and drained the state budget.

Replacing state bureaucrats with private owners as part of a thorough program of market reforms promised significant improvement. Private owners would not long tolerate managers who subtracted value from production. Ideally, private owners would restructure the firms to deliver a profit. Many would fail, but in failing they would release valuable labor and capital to be picked up by other entrepreneurs. Eventually, this "creative destruction" would lead to a more productive economy—one that would produce better quality products, in greater quantities, with the country's available resources (Schumpeter 1975: 82).

Advocates also expected privatization to produce important political change. New owners would soon understand that the old political and economic way of doing things diminished their bottom line. They would demand laws that protected their property; they would demand judges that enforced the law rather than the whim of corrupt officials or political strongmen; they would seek the right to replace corrupt or antibusiness bureaucrats with ones who promoted economic freedom; they would fight for their right to organize themselves to lobby for a freer political and business environment. Most importantly, in countries where former communist authoritarians still held sway, a private business class would demand political elites who would behave themselves—nurturing the business environment, rather than preying on it. Economic reforms like privatization would thus help drive liberal political change. This was a good reason to privatize even under undemocratic or corrupt conditions (Boycko, Shleifer, and Vishny 1995: 154; Shleifer and Treisman 2000: 38).

This book takes a skeptical look at this prescription. Its origins are in an assassination that occurred in 1996 outside my apartment in Slovakia as a political battle over state property and democracy was reaching its peak. Since late 1993, Slovakia's president, Michal Kováč, had been speaking out against the increasingly authoritarian policies of Vladimír Mečiar, Slovakia's prime minister. Chief among his accusations was that Mečiar was using the privatization process to enrich friends and associates.

Mečiar was looking for an opportunity to embarrass and discredit the president. In August 1995, members of the Slovak Information Service (SIS) kidnapped President Kováč's son, Michal Kováč Jr., and left him on the Austrian side of the border. He was alive, but had passed out after being beaten, tortured, and forced to drink a bottle of whiskey. Kováč was wanted for questioning in Germany in relation to a fabricated financial scandal. His kidnappers apparently hoped that the Austrians would deliver him to the German authorities. Instead, the Austrians returned him to Slovakia, where his abduction provided additional fuel to Mečiar's opponents.

On April 29, 1996, Robert Remiaš was returning from a meeting with the editor of a leading newspaper when his BMW exploded several hundred meters from my apartment. Remiaš was the friend and confidant of a former SIS agent who had worked with the team to kidnap the president's son. The agent had told his story to the police and had gone into hiding in Hungary. Remiaš was now serving as his go-between. As evidence of SIS involvement began to mount, Mečiar's government squashed the investigation—replacing three investigators before finding one who suspended the inquiry into the SIS link. The new investigator concealed evidence that 150–200 grams of Semtex had ignited the car's propane tank. Now on the defensive, the SIS launched a campaign to show that Kováč Jr. had arranged for his *own* kidnapping (Deegan-Krause 2006: 49–50; Williams 2001: 130–140).

Ironically, on the Friday evening when Remiaš's exploding car rattled my windows, I was reading an exciting new book by several leading economists who had assisted with Russia's troubled privatization program. I had only minutes before read the line: "the principle objective of reform was . . . to depoliticize economic life" (Bocyko, Shleifer, and Vishny 1995: 11). In particular, the authors felt privatization would perform this trick by cutting ties between politicians and enterprise managers—enabling the latter to seek profits for firm owners, rather than provide jobs and other perks to disgruntled voters.

Remiaš's murder prompted me to ask whether these mostly well-meaning economists were missing a crucial aspect of the privatization story. Privatization is not expected to be associated with assaults on democracy, kidnapping, and murder. Economic textbooks rarely discuss its dark side. Yet, politically, postcommunist privatization is a high-stakes game that distributes wealth to some people and not others. With such enormous prizes, many postcommunist politicians preferred to win by cheating at the rules. In addition, privatization programs were launched in postcommunist Europe while these rules were still emerging. Where politicians felt that more democracy would deprive them of control over the privatization process, they had an incentive to resist it.

More broadly, privatization helped reveal the important role liberal politics played in Europe's postcommunist economic transformations: a state's degree of political liberalization was an important predeterminant of the direction and pace of economic reform. Liberal politics came first; in their absence, liberal economic reforms were unlikely to follow (Hellman 1998; IMF 2003: chap. 3). Where communist-era political elites did not face a robust challenge from opposing parties and civil society, the incumbents usually controlled the introduction of postcommunist political institutions. This allowed ex-communists to limit and subvert economic reforms and provided them with opportunities to benefit at everyone else's expense. Nor was there any political mechanism to release the grip ex-communists had on political and economic power (Vachudova 2005).

Control over privatization was perhaps the most important stake in this game. Where society exercised only a weak political check on ex-communist politicians, the political elite could limit or manipulate others' access to the privatization process. The result was that much of postcommunist Europe's wealth and power concentrated into the hands of small groups of the politically connected (Hoff and Stiglitz 2005).

Once these political and economic insiders became owners, they often did not behave as the economists had hoped. Privatization often came before institutional structures were in place that would force the new owners to behave themselves. Worse, reformers' belief that private economic agents would subsequently demand these structures led economic reformers to ignore the need for legislation to create them before or during early privatization efforts.

In the meantime, the postprivatization context was rarely as rosy as economists envisioned. Rather than revitalize their enterprises, new owners often stripped out their value. Rather than lobby for reforms enhancing economic competition, they frequently lobbied for monopolies. Rather than demanding law-abiding politicians, they all too often collaborated in political corruption. In short, while privatization was supposed to produce entrepreneurs who would push for democracy and efficient markets, the combination of privatization and illiberal politics spawned oligarchs who fought against such improvements. Where economic reforms did emerge, it was usually because some form of economic dysfunction was starting to hurt the oligarchs' interests.

Privatization arguably worked better in more democratic postcommunist countries. Liberal politics gave privatization processes more legitimacy. Although highly resented by many, new owners were less likely to be threatened by democratic institutions. In addition, while policymakers often bungled aspects of privatization, relatively robust democratic institutions ensured that the beneficiaries of the privatization errors were eventually exposed and major policy mistakes addressed. Although privatization in democratic countries also concentrated wealth and produced corruption, a more competitive political environment helped ensure that there were limits to what the winners could do with their wealth and power (Hellman 1998; Orenstein 2001; Vachudova 2005).

Economists often assert that economic dysfunction is the result of a lack of skill and will among politicians. This book demonstrates, by contrast, that for many forms of economic dysfunction, there is a beneficiary kept in place by illiberal politics. Economic reforms help, of course, especially when they force private owners to earn a profit rather than to lobby for it. But where these beneficiaries remain in control, chances of getting meaningful economic reform are slight (IMF 2003: chap. 3). In postcommunist Europe, the best fix for economic dysfunction has proven to be more robust political competition.

Unfortunately, political competition emerged in only a handful of postcommunist countries in the 1990s. In the majority, the collapse of communism did not effectively unseat the old order. Control over the political framework gave incumbents control over the privatization framework—a mechanism that politicians used to distribute wealth and power to themselves and their allies.

The news is not all bad, however. Some observers initially feared the tight connection between wealth and illiberal power would become stable over time—an undemocratic equilibrium in which the interests of the newly emerged business class would prove permanently inseparable from the privileged and often oppressive control of its political patrons (Hellman 1998). As privatization advocates hoped, however, this arrangement proved to be quite fragile in a number of countries. Political strongmen in Slovakia, Croatia, Serbia, Georgia, and Ukraine found that oligarchs can be unreliable allies (Levitsky and Way 2002). During moments of greatest government weakness, important business actors often defected to oppositions that promised a more rule-governed political and economic environment.

This observation provides us an opportunity to reconcile advocates of privatization with their critics. In the short run, privatization was indeed used by former communists and others to consolidate their control over the political and economic life of the country. In the long run, however, many privatization beneficiaries lent their support to movements promising democratic political change. Often, they defected because the regime had become so predatory that it left them no choice (Junisbai 2009). Other times, businessmen were simply seeking to hedge their bets during a crisis, hoping to protect their interests should the new government win. Yet, as privatization advocates predicted, the temptations toward defection were also greater where private owners already had to produce a marketable product to survive (Wilson 2005). To the extent that previous economic reforms forced them to do this, economic reforms could be a force for political liberalization. Conversely, this defection temptation was weaker where the dominant business class remained dependent on political connections, rather than entrepreneurial skill, to generate a profit. It was weaker still where the regime further cemented elite loyalty through clan-based identity ties or lucrative oil rents. To the extent that a regime change threatens postprivatization elites' access to policies that guarantee them earnings, they adhere to the regime or limit their defection to a strategic effort to preserve their perks should the opposition prevail.

Outline of the Book

This book is for scholars and policymakers, but I would also like it to be accessible to my undergraduate students—the generation born after the fall of the Berlin Wall. So much of the work on the postcommunist period assumes a wealth of knowledge about communism and subsequent events that this generation has had no reason or opportunity to learn. With this in mind, Chapter 2 offers a brief schematic of the nature of communist-era political economy and a review of debates among economists on how to replace it once it collapsed. Chapter 3 develops the debate. It pays particular attention to privatization's theoretical role in the economists' broader vision for transitioning communism into capitalism, and it covers new ground by developing a theoretical response based in political competition theory.

Chapters 4, 5, and 6 then turn to the rich empirical political story of privatization in federal Czechoslovakia and its successor republics. Democratic Czechoslovakia is a cautionary story: the design of its privatization framework reflected the relatively powerless position of communist-era managers and employees, but this did not mean privatization was well conceived. Chapters 4 and 5 will explore the political origins and ramifications of the privatization design choices made by Václav Klaus, federal minister of finance, and others. In his subsequent role as prime minister, Klaus benefitted from the privatization program and arguably some of its flaws. Given that many associated with the governing coalition benefitted from deficiencies in the program, correcting them proved difficult. Ultimately, necessary additional change required a change in government—a change made possible by the country's comparatively robust political institutions.

In Chapters 4 and 6, by contrast, we see how Mečiar, three-time Slovak prime minister, rose to power with the support of those who felt most threatened by Klaus's federal privatization program. Mečiar is notorious for having pushed Slovakia's democracy and market economy to the edge in the mid-1990s. The politics of privatization played a role. Whereas communist-era managers and bureaucrats in the Czech Republic had been initially discredited by their close association with the communist regime, in Slovakia, the same sorts of people found an important resource in nationalist concerns that federal economic reforms like privatization were not appropriate for Slovakia's somewhat more difficult economic challenges. Mečiar sympathized with these concerns and used them to strengthen his leadership over the movement for greater Slovak political and economic autonomy.

After independence on January 1, 1993, Mečiar began to reorient Klaus's privatization program toward a program of easy sales to his political allies. These controversial and clearly self-serving steps provided his opposition in the National Assembly, the press, and civil society with additional fuel for criticism. Mečiar's parliamentary majority responded by concentrating power and disregarding democratic procedure to a point where the European Union (EU) excluded Slovakia from membership negotiations on political grounds in summer 1997. Mečiar's closest privatization winners used the increasingly undemocratic climate to secure for themselves favorable economic policies that suppressed investment, undermined the financial system, and threw the economy into a deep imbalance. The government, meanwhile, attempted to hide its self-dealing behind a nationalist cover story about the patriotism of its supporters and the anti-Slovak designs of its critics. While privatization was not the only cause of the democratic and economic distortions in Slovakia from 1993 to 1998, it was certainly a contributing factor.

Fortunately, the Mečiar era came to a swift close in 1998. An unprecedented 84.4 percent voter turnout and a unified opposition—including some important economic actors who were concerned about Slovakia's weakening business prospects—forced Meciar and his allies into the opposition. While Mečiar-era economic distortions would take years to fix, and while the fixes were not without mistakes or scandals themselves, the democratic breakthrough of 1998 remains the seminal moment in the country's post-communist development. Slovak citizens had established their ability to hold their elites accountable for political and economic mismanagement.

From Slovakia, Chapter 7 turns to Ukraine—a country whose post-communist trajectory was brokered by former communists. Newly independent after the dissolution of the Soviet Union in 1991, Ukrainians had little say in the establishment of post-Soviet political institutions or economic policies. Ex-communist political elites managed the process and for most of the 1990s they did so in ways that allowed them to transform their privileged positions under communism into political privilege and often vast material wealth in the postcommunist period. Robust and competitive, Ukrainian politics was nevertheless mostly an elite-brokered fight between regional ex-communist elites and the occasional upstart over the wealth of the former Soviet republic. From 1994 until 2004, President Leonid Kuchma served as the elite's chief broker, a position he managed with the assistance of regional power holders, a powerful and politically obedient presidential administration, a politically directed media, a diluted and personalized party system, managed elections, murder (allegedly state directed), and financial and physical intimidation.

Privatization initially took a form that resembled the mass privatization policies designed by Klaus to do an end run around communist insiders. In practice, however, the politically connected manipulated the program from the start to ensure that they would retain control over assets. Private ownership of Ukraine's industrial landscape initially did little to revitalize the economy. New owners stripped their enterprises or sought guarantees of profit through protectionism or favorable financial and commodity policies. For most Ukrainians, the result was a dismal decade of decline into deeper poverty.

As Ukraine's economy grew increasingly weak and vulnerable to external shocks, the country's elite agreed to market reforms: first, in 1995–1996, the stabilization of the currency; and second, in 1999–2001, the elimination of many of the major market distortions. The second round of reforms, under the leadership of ex-banker Victor Yushchenko, helped set the country on a path to recovery. As postprivatization entrepreneurs lost their protections and privileges, they had to restructure their firms to produce goods or services that the country and the rest of the world would buy. The timing was perfect as export markets for Ukraine's primary industrial goods—particularly steel—drove robust growth for a solid five years.

Yet, Prime Minister Yushchenko's reform campaign struck at the vital interests of the country's most important economic players—particularly in the coal and steel industries. While this sector's main players favored a state-enabled industrial policy that improved their competitiveness, the policy relied heavily on large subsidies to the country's ailing and costly coal sector. Steel-sector leaders also reinforced an illiberal political system in which they and other regional power brokers had asymmetric access to political information and power. As Yushchenko's reforms began to threaten these arrangements, power brokers in steel and coal secured his removal—to be replaced a year later by one of their own.

Over the next three years, tensions between the winners and losers of Ukraine's political economy mounted, culminating in a fiercely contested presidential election in fall 2004. An opposition-led mass movement refused to acquiesce in a fraudulent election. As in Slovakia, postprivatization entrepreneurs lined up on both sides of the contest; Kuchma's elite economic supporters did not offer a solid front. Some may have crossed "honestly" to promote an environment in which investment is protected, rather than discouraged, by the state. Others opportunistically crossed lines in hopes of getting a better deal with the new party of power; one suspects that a major concern was to ensure that cheaply acquired properties would not be reacquired by the state.

By no stretch of the imagination did Ukraine's business elite lead the democratic opening of 2004, also known as the Orange Revolution. At best, a subgroup of business leaders played a supporting role to a mass movement that sought political liberalization. At worst, business leaders stubbornly clung to the Kuchma regime in an effort to retain their privileged access to state policies that fattened their bottom line. As in Slovakia, however, Ukraine's chance to liberalize its political system came from a unified opposition backed by a mobilized and peaceful civil society.

From Ukraine, Chapter 8 travels both east and south to look at the politics of privatization in Serbia, Georgia, and Azerbaijan. The three countries differ in theoretically interesting ways. First, Azerbaijan has the only resource-dominated economy in the book—its elites derive wealth primarily from access to state-directed energy resource rents. Second, Azerbaijan and Georgia share strong kin-based clan identities that can serve as an important organizing framework for economic policies like privatization. Serbia, by contrast, lacks both kinship distribution networks and energy resource rents. The three countries are similar, however, in that each was led by undemocratic postcommunist leaders who used the privatization process and economic policy to reward supporters and punish opponents. Each leader also attempted to remain in power through a fraudulent election leading to a regime crisis.

In Azerbaijan, we see how the country's main economic elites remained loyal to the regime throughout the contested 2004 presidential election and subsequent elections. I argue in Chapter 8 that the logic of democratic institutions was incompatible with a system of power based on the distribution of resource wealth through tight kinship and business networks. In resource-poor societies, unconstrained government power is frightening to capitalists. To do business, they must often purchase political protection or risk having their capital stripped by those with better connections. There are many incentives to support a movement toward political liberalization that will call predatory politicians and bureaucrats to account.

In resource-rich societies, by contrast, this logic is less important. While individual capitalists may flee the grabbing hand of the state, oil, the source of wealth generation, remains safely trapped in the ground. Accessing this wealth does not require the complex institutions typical of most market democracies. The rule of law, for example, may give political outsiders avenues by which to challenge the ruling elite's privileged access to oil profits (Easterly 2006: 125; Fish 2005: 137; Ross 2001). Yet, sharing this access may also prove an effective means of dividing opposition groups and buying societal acceptance of illiberal rule. Worse, foreign need for a strategic resource like oil will temper international criticism for domestic authoritarian behavior. In sum, where oil is present, the regime may face less pressure to democratize.

The 2004 elections thus served as a turning point in Azerbaijani regime development. After a period of political liberalization that held out the promise of genuine democratization, the leading kinship clans closed ranks with the ruling Aliyev family as security forces suppressed a strong opposition movement. In contrast to the other cases in this book, Azerbaijan took an authoritarian turn.

Serbia and Georgia by contrast do not enjoy the dubious benefits of oil wealth. In both countries, however, the end of communism was dominated by illiberal political leaders who nontransparently manipulated privatization and control over state properties. Government opponents united with each other and mass movements to challenge this control in 2000 and 2003 respectively, when the government in power tried to steal an election. Unlike in Azerbaijan, however, many leading economic elites defected to support or, at least, to hedge their bets with the opposition. Georgia's regionally based clan system appears to have accelerated the breakdown of central power. Without oil rents to cement loyalty, formerly strong supporters scrambled for the best deal from the new center of power. In Serbia, pro-government business forces similarly made deals and even financially supported the opposition.

In the opening epigraph, Adam Smith warns of "the mean rapacity, the monopolizing spirit of merchants and manufacturers, who neither are, nor ought to be, the rulers of mankind" (1776). Smith had it right then, as he does now. If there is a lesson to be drawn from this book, it should be that where economic agents gain unobserved and unchecked control over the public sphere, they can wreak havoc on the public interest. In reading this book, I hope students of postcommunist politics will come to a further appreciation of the role that societies must play in policing the intersection of business and politics. The solution to the rapacity of the merchants and manufacturers is neither better businesspeople nor better politicians; it is a healthy and skeptical civil society with the rights and freedom to hold their political leaders accountable.