VOLUME 3

PUBLIC SECTOR REFORM

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VOLUME III

Reform after the Cold War

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PUBLIC SECTOR REFORM

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Comparative Theft: Context and Choice in the Hungarian, Czech, and Russian Transformations, 1989–2000

Andrew Barnes

Why were some post-communist political economies by the year 2000 characterized by impenetrable cross-ownership groups, money-laundering banks, and captured states, while others had effectively limited corruption and laid the groundwork for long-term development? I argue that different patterns of asset misappropriation led to these outcomes. Most studies of post-communist transformations, however, see the scramble for property since the 1980s as an undifferentiated phenomenon across the region. A comparative examination of this process sheds light on how some formerly communist countries found themselves on very different paths of development than others by the beginning of the twenty-first century.

In particular, based on a comparison of Hungary, the Czech Republic, and Russia, I argue that important variations in post-communist political economies were caused by a combination of two factors: (1) the context of state-economy relations at the end of the Communist Party era and (2) the choices made by new governments on how to control the transfer of state assets to the private sector. By the end of the 1980s, governments in each of the Soviet bloc countries faced new challenges from emerging economic actors. States varied, however, in their ability to make those new entities play by universal rules, and those differences in administrative capacity set the stage for developments after the communist parties gave up their

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political hegemony. Conditions between 1989 and 1991 did not entirely determine outcomes by 2000, however, and the second critical phase in the development of post-communist political economies came early in the new governments' tenure, when they decided whether and how to regulate the transformation of ownership. New governments that took a laissez-faire approach to economic restructuring either exacerbated earlier problems or squandered initial advantages for limiting the misappropriation of assets. By contrast, governments that followed a more hands-on strategy of industrial and financial privatization during the first post-communist decade, in the face of international opprobrium, were able to limit the structural damage to their economies.

The aims of this article, therefore, are twofold. The first is to differentiate systematically among the outcomes to be explained – that is, the broad contours of the political economies under investigation. The earliest Western studies of post-communist privatization were not designed to notice, much less explain, significantly different results from a process understood as a move toward markets and democracy. Instead, comparisons emphasized aggregate measures of the percentage of property in private hands, presumably a measure of progress along a unidimensional path toward a better future, rather than focusing on structural differences that might represent cul-de-sacs of political and economic development. Misappropriation of assets was a part of the transition economy that would disappear with greater marketization, and "lagging behind" on this journey was generally attributed to the weak spines of "reformers" or the malicious intent of "hardliners" rather than to anything systemic.[1]

By the late 1990s, the dominant paradigm for thinking about post-communist property reform had shifted, but still not in a direction that allowed for clear comparative analysis. A wave of scandals began to challenge the teleological conception of the "transition." Russian high rollers flaunted wealth while workers went unpaid; a private Czech bank made a crippling series of bad loans and left the state to deal with the aftermath; a Romanian investment fund went bankrupt, taking citizens' savings with it; Hungarian officials were investigated for their role in the privatization of the state oil company; and the Polish treasury minister was removed amid allegations of shady privatization deals. It often seemed that the entire region was mired in a suffocating morass of bribery and venality. Despite these surface similarities, however, the outcomes of property reform varied substantially across the region by the end of the 1990s, producing systems characterized by what I have labeled "asset development," "asset limbo," and "asset destruction" (see Table 1). The first task of this article is to clarify those categories.

The second is to explain the different outcomes. The studies that seem most likely to shed light on this question are those concerned with various aspects of "nomenklatura privatization" – the transfer of wealth from the state to former economic and political elites and their allies. There are at

Table 1: The three political economies by 2000

Role of…	*Asset development (Hungary)*	*Asset limbo (Czech Republic)*	*Asset destruction (Russia)*
Conglomerates	Moderate	Large (perhaps expanding)	Dominant
Banks	Largely investors for growth	Some in webs of asset stripping; some acting as responsible lenders	Largely facilitators of asset shifting
State	Set and enforced rules of the game (macro-regulator)	In danger of being captured	Captured by major economic actors

least three different types of such investigations, each of which makes important contributions to our understanding of the region. The first and most common is the journalistic account of asset misappropriation, often with an emphasis on the Russian"oligarchs."[2] These studies contain many anecdotes about the theft of state resources, but they are not systematic analyses. A second body of scholarship comes out of sociology and investigates the social origins of the new elite in Eastern Europe.[3] It does not, however, typically draw out the economic and political implications of those origins. Finally, a third type of study provides deep insights into the process of nomenklatura privatization within individual countries but does not take an explicitly comparative approach to investigation.[4] This article builds on some of the insights provided by these earlier studies, but it does so in the context of a structured comparison.[5] In particular, it shows that some governments were able to limit the effects of nomenklatura privatization at the end of the Communist Party era better than others and that early post-communist decisions to leave control of economic restructuring to market forces undermined future development.

The Cases and the Comparisons

The argument in this article is based on a comparative study of Hungary, the Czech Republic, and Russia. These cases were chosen to offer wide variation on the spectrum of outcomes – described below – while at the same time holding constant several background characteristics that might have been expected to drive the differences.[6] In particular, all three of the cases had moderately high gross domestic products (GDPs), well-educated populations, and industrialized economies at the time of transition; and they all engaged in significant consultations with Western economic and political advisors.

In characterizing these countries, this article focuses on three fundamental aspects of their political economies at the end of the 1990s. First, it examines the prominence of large ownership conglomerates. Conglomerates represent the possibility of monopoly power, whether in economic relations or in the pursuit of influence in politics, so it is important to take account of them. Second, the article considers the role of banks – did financial institutions funnel assets to and from firms to which they were closely linked, or did they exist largely to finance investment for growth? Large banks, especially if they have close ties to large firms, may not be the engines for long-term growth that liberal economic theory expects.[7] And finally, it discusses the position of the state in the political economy – by the end of the first post-communist decade, did the government act largely as a detached macro-regulator or was it captured by rent seekers?

No classification scheme can capture all of the facets of its cases, but there are several reasons to think that the attributes included here are the ones that deserve our greatest attention. First, the three main players in these political economies as of the late 1990s were clearly industry, finance, and the state. Second, the political and economic questions of greatest domestic and international concern in these countries – including capital flight, investment levels, income disparity, and the organizational capacity of social groups – were most heavily affected by the three characteristics described here. Finally, this classification scheme follows the emphases in several works on the comparative political economy of capitalism. John Zysman, Stephan Haggard, and Robert Wade, for example, have all stressed the importance of industrial, financial, and state organization for understanding both economic performance and political development.[8] The classification of cases for this article is summarized in Table 1.

Hungary (Asset Development)

Cross-ownership groups have attracted considerable attention from scholars of post-communist Hungary. Especially in the first years after the fall of the old regime, it seemed that these large-scale networks of ownership and control might come to dominate the Hungarian political and economic scene in the 1990s.[9] Early statements of this development, however, were based largely on a close examination of one such arrangement – the conglomerate called "Heavy Metal" – and the more recent versions rely heavily on ownership maps that do not distinguish between different sizes of shareholdings.[10] Since those initial studies, several other scholars have conducted investigations that downplay the role of large ownership networks in the Hungarian economy.[11] Certainly conglomerates existed at the end of the past decade, but they were not the defining characteristic of the political economy.

It is also important to note that even where several firms *were* united in a cross-ownership web in Hungary, banks rarely played a strong role within the group. Instead, as David L. Bartlett has shown, Hungarian banks *withdrew* from the enterprise sector in terms of both lending and ownership after 1990.[12] This is not to say that banks played no role in the enterprise sector, of course. Instead, it suggests that Hungarian banks generally restructured their loan portfolios, jettisoned their holdings in weak firms, and pursued profit through investment financing much more quickly than did banks in the other two cases.

As in all post-communist countries, the Hungarian state maintained a presence in the economy at the end of the 1990s. Its support of specific firms and industries, however, was significantly lower than it had been at the time of the fall of the old regime. Furthermore, in practice, the Hungarian state did not typically assert its ownership rights by micromanaging firms in which it still held a large share or by preventing such firms from going under.[13] Instead, its role was to set general guidelines and minimize the extraction of rents. Overall, this combination of a moderate role for conglomerates, a financial sector engaged in investment financing, and a state that played the role of macro-regulator places Hungary in the category of "asset development" for the purposes of this article. By the year 2000, its political economy was structured to encourage a more productive long-term use of resources than either the Czech Republic's or Russia's.

Czech Republic (Asset Limbo)

The most notable features of the post-communist Czech political economy at the end of the 1990s were the prevalence of cross-ownership arrangements and the prominent position of banks in those networks. Within the first few years after the fall of the old regime, the largest banks in the country had acquired shares in a substantial number of enterprises for little or no cash by participating in the country's voucher privatization program.[14] In addition, not only were the big banks able to buy pieces of privatizing enterprises, but several of the banks and investment funds owned pieces of one another.[15] By the second half of the 1990s, this pattern of extensive bank and firm cross-ownership had developed further, and several large conglomerates dominated the Czech economic horizon. For example, Škoda Plzen, an engineering firm, leveraged loans from a closely affiliated bank to buy controlling stakes in more than forty enterprises, including some that produced truck parts, cigarette-rolling machines, and even nuclear reactors.[16] Chemapol, a chemical company, likewise worked with its bank to expand upstream, downstream, and into new product areas, eventually overextending itself and falling into receivership in 1999.[17]

The point, however, is not simply that conglomerates existed or even that some were unprofitable. Rather, it is that some of them existed to divert funds from the state or from shareholders to small groups. The Czechs began to call the process "tunneling": the "investors" purchased a bloc of shares in an enterprise, frequently with borrowed funds, and stripped assets – "tunneling" them out of the company – usually by means of transfer pricing.[18] The first such scheme to gain notoriety was carried out by a group called Motoinvest. Beginning in 1994, fifteen young people began buying up shares in several

Czech companies.[19] Then in 1995, they purchased a controlling stake in a provincial bank in Plzen through a third party. With access to a bank, Motoinvest had leverage to expand its holdings rapidly, and by 1997, this small firm had acquired approximately $3 billion of assets (including a second bank, called Agrobanka), much of which it then pumped out of the country.

At the end of the 1990s, the Czech state was still able – if only barely – to constrain this process of asset stripping to some degree. For example, through a newly created Securities Exchange Commission and through the Central Bank, the government finally froze Motoinvest's assets in 1998.[20] It also developed an increasingly professional bank-monitoring division, which met regularly with its Western counterparts.[21] Still, some of the new private economic actors in the country were clearly growing large enough to challenge state power. This state of affairs has been labeled "asset limbo" in Table 1, to suggest that the Czech Republic was teetering on the edge of going the Russian route at the end of the 1990s.

Russia (Asset Destruction)

Conglomerates were huge players in the Russian political economy by the late 1990s. Most familiar were the so-called "oligarchs" – Gusinsky, Berezovsky, Potanin, and others – who seemed to control an enormous part of the Russian economy.[22] This phenomenon, however, was even more extensive than coverage of the biggest names might suggest. For example, ownership groups had developed not only in the mass media and natural resource sectors but also in the metals industry,[23] tire manufacturing,[24] and even agriculture.[25] The aluminum industry, in particular, was the site of the most prominent spate of acquisitions (often enforced by violence) in Russia in 2000.[26] In addition, large ownership groups were not just based in Moscow but scattered throughout the country, frequently with the participation of regional and local governments. The example of Volgograd oblast is illustrative. The regional holding company in that oblast, "Sfera," was established in 1994 by the oblast administration, representatives of LUKoil, and some smaller partners.[27] By the end of 1998, the company had restructured its holdings to include control over enterprises at every stage in the chain of petrochemical production.

Banks played a prominent role in the development of the post-Soviet Russian political economy in the second half of the 1990s, although not the role many analysts expected. In 1995 and 1996, some Russian financial institutions acquired large shares of potentially profitable firms for very little money, and several observers thought those banks might invest capital and nurse the enterprises back to health. In the final years of the decade, however, banks in Russia served largely as conduits for capital. They funneled money from the state budget to enterprise directors, channeled cash out of the country, and generally served as accountants in financial deals rather than as sources for real investment.[28]

The Russian state, for its part, seemed so incapable of influencing events and actors by the end of the 1990s that scholars began to call it "weak," "privatized," and even "feudal" in the way its authority had been"parcelized."[29] Several patterns reinforced this impression: President Yeltsin frequently reshuffled his government to prevent a palace coup, the Central Bank was unable to develop or implement a plan for consolidating the banking sector in the wake of the financial crisis of 1998, the central government could not collect enough taxes to fund a shrinking budget, and even the relatively powerful regional governments seemed unable to control natural resource exporters on their territory.[30] With its dominating conglomerates, uncontrolled banks, and incoherent state, the Russian political economy at the end of the 1990s was better structured for capital flight than for capital investment, earning it the "asset destruction" label in Table 1.

Explaining the Outcomes

I argue that these different medium-term outcomes were caused by two earlier developments: first, the changing relations between economic actors and the state near the end of the Communist Party era; and second, decisions in the ensuing years about regulating the flow of assets to private hands. (This argument is laid out in schematic form in Figure 1.) The historical context for the development of post-communist political economies was strongly shaped by the way the old regimes broke down. During their final decades, all Communist Party regimes faced twin dilemmas of improving economic performance and maintaining political stability. They differed significantly in how they chose to address those problems, however, with varied consequences for their ability to constrain the destructive behavior of economic actors by the time the regimes fell. The Hungarian government encouraged the slow, regulated development of a private sector within a statist economy as early as the 1960s. This experience meant both that the post-communist government was not thrust into an arena of de facto uncontrolled private enterprises and that the new government's leaders had seen the potential benefits of a regulated economic transformation. The Czechoslovakian state also retained its ability to constrain economic actors, albeit by different means: it had strongly resisted structural change after 1968, relying instead on both increased investment in consumer goods to buy social peace and fiscal discipline to create a buffer against external pressure. In the Soviet Union, by contrast, reforms under Khrushchev and Brezhnev strengthened the hand of ministries and enterprise directors against central planners. When Gorbachev further increased the autonomy of large economic actors in the late 1980s, they helped bring down the USSR, gathering economic and political power to themselves at the very time a new Russian government was trying to establish itself.

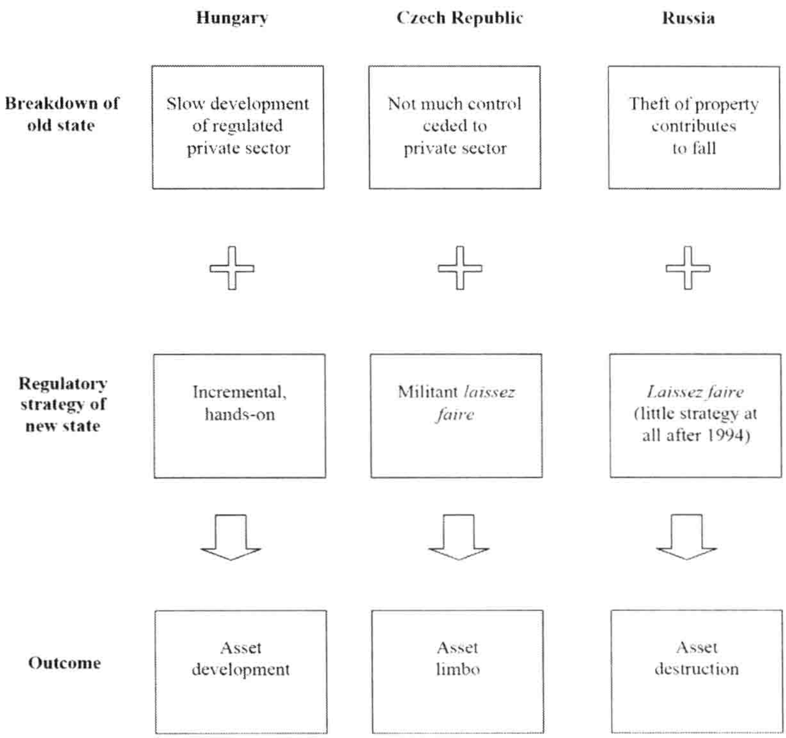

Figure 1: Explaining the outcomes

Those developments set the stage for what came next, but they did not entirely determine the outcomes described in the previous section of this article. Regulatory strategies adopted in the first years after the fall of the old regimes sometimes built upon strengths inherited from the previous years, sometimes squandered them, and in other instances made a bad situation worse. In Hungary, the new government actively sought to prevent the rapid expropriation of the country's wealth by new private industrial or financial actors, and it largely succeeded. The post-communist Czechoslovakian leadership, by contrast, chose a very hands-off approach to economic restructuring, and by the end of the 1990s, it stood in danger of losing control over unhealthy economic activity. Finally, the new Russian government likewise embarked on a path of laissez-faire economic reforms, but since the Russian state had begun the process from a weaker position than the Czechoslovakian state, economic actors were able to take even greater advantage of it.

Hungary

The Hungarian case of "asset development" began with the cultivation of a regulated private sector before 1989, which was followed by a controlled transfer of state property to private owners through regulation of the banking sector and the privatization process. The emergence of a limited private sector in the communist era began in 1968 with the introduction of the New Economic Mechanism (NEM).[31] That program ceded ground to the unofficial private (i.e., "second") economy and transferred some decision-making rights to enterprise managers by abolishing compulsory plan targets for enterprises and giving managers permission to find their own business partners.[32] A recentralization campaign in the 1970s slowed, and in some cases reversed, this devolution of economic control, but it did not return the system to its pre-1968 form.

After the second oil crisis and the concomitant tightening of international lending flows, the Hungarian leadership returned to a strategy of decentralizing economic decision making and tolerating – even embracing – market relations in some parts of the economy. A 1982 decision, for example, legalized several types of private partnerships and set no limits on the amount of money entrepreneurs could invest in those enterprises.[33] Moreover, in 1984, the Law on Enterprise Councils established committees, drawn half from management and half from the workforce, that were to make firm-level decisions on such issues as choosing chief executives and making organizational changes.[34]

On their own, these laws did not dramatically affect the operation of firms or the Hungarian economy, but beginning in 1988, three new decisions opened the door to more significant changes. The Law on Foreign Investment (1988) created a favorable environment for private foreign firms, the Corporation Law (or Company Law) (1988) made corporate ownership legal, and the Transformation Law (or Conversion Law) (1989) allowed state enterprises to go public (i.e., sell shares in themselves).[35] Between 1988 and 1990, many state enterprise directors took advantage of the new laws to transform parts of the enterprises they managed into private firms, often leaving a piece of the state enterprise as a holding company in the middle.[36] In thinking about the strength of the Hungarian state, however, it is important to notice that "spontaneous privatization" in Hungary was *not* taking place through subterranean channels but rather in response to encouragement from above.[37] This arrangement allowed the state to monitor the process and, as we will see in a moment, to regain control over it when it fell out of favor (in direct contrast to the Russian case).

Likewise, banking reform in Hungary in the 1980s did not spawn myriad unregulated financial institutions. Rather, the state broke off the enterprise loan portfolio of the Hungarian National Bank in 1987 and distributed the assets among five new commercial banks in a relatively orderly fashion.[38] The boards of these banks were afraid that denying new loans to enterprises in arrears would bring the banks down, so the government was unable to force them to reorient their loan portfolios toward more efficient enterprises.[39] Nonetheless, by restricting lending, the Hungarian government did prevent banks from serving as conduits for massive capital flight, as occurred in Russia.

After the fall of the old regime in 1989, the new government resisted international calls to move rapidly on industrial and financial privatization. Experience with relatively successful gradual reform since 1968, along with an international debt burden that made it imprudent to sell enterprises at fire sale prices, prompted the new leadership to expand opportunities for the private sector in a controlled fashion.[40] For example, when public sentiment turned against the process of spontaneous privatization, the Hungarian government was able to bring it largely to a halt by creating an agency to coordinate the process. The State Property Agency (SPA) was established in 1990, and for the next year and a half nearly all privatization decisions had to go through that agency.[41] The banks could not strike special deals with the state to acquire property, and enterprise managers were significantly restricted in their efforts to strip the state of assets and leave it with liabilities.

Even in 1992, when the SPA turned to a policy of "enterprise-initiated" privatization, it was able to establish and enforce rules that regularized the process. By that time, it had dramatically expanded its capacity to monitor the process. Its staff had grown from forty to two hundred, it was subordinated directly to the prime minister (rather than the more fragmented parliament), its decisions were no longer subject to judicial review, and it had been granted the right to review enterprise-initiated privatization decisions.[42] Perhaps most important, although the SPA did not pore over every privatization decision, it did monitor the consulting firms that were hired to develop privatization plans for enterprises.[43] While this approach was open to rent seeking on the part of the consulting firms, it was a far easier task for the SPA to monitor them than to deal with each individual enterprise undergoing privatization. As the task of privatization was becoming more complex, the SPA was delegating authority in a fashion that still made it possible to regulate the process with comparative success.

This case-by-case, cash-based privatization program was much slower than the approaches of the Czech Republic or Russia, and several scholars criticized it because it left the state with a larger ownership role than elsewhere in the post-communist bloc.[44] In practice, however, the Hungarian state set up institutional barriers to prevent itself from micromanaging and/or supporting indefinitely the firms in which it owned shares. For example, a law passed in 1992 automatically launched bankruptcy proceedings against any firm with more than ninety days of loan arrears.[45] Particularly since banks received no privileges in such proceedings, this arrangement made it unwise for banks (even the ones with large state ownership) to buy up and support weak enterprises.[46] In another instance, the government severely limited its ability to borrow from the Central Bank to cover deficits.[47]

After the first round of economic reforms (that is, by 1993 to 1994), the chief question for Hungarian economic reform was what to do with the leading banks in which the state still held large shares. Here again, the state was able to assist in the economic transformation without becoming captured by the new actors it was creating. Four times the government injected new capital into the big banks, but each time it imposed new regulations on the banks to make them more sound.[48] In particular, it raised reserve requirements and clarified accounting practices. The result was that the banks began to restructure themselves, and between 1994 and 1998, they were privatized to foreign investors.[49]

The Czech Republic

The Czech Republic followed a different path. In some ways, it was in a better position to prevent economic destruction in 1989 than Hungary or Russia, since the state appeared to be very much in control of society in the late 1980s. The new government, however, pursued a resolutely laissez–faire approach to economic reform, which gave banks and other economic actors considerable power without close monitoring of their activities.

The tight government control of the economy and polity in Czechoslovakia after 1968 contrasts sharply with the Hungarian experience of the same period. This difference is largely due to the events and aftermath of the Prague Spring in 1968. While Hungarian leader János Kádár negotiated with the Soviets for room to experiment with market reforms in the 1960s, the Prague Spring in Czechoslovakia prompted a violent reaction from the USSR, bringing Gustáv Husák to power. His government embarked on a path of "normalization," which meant undoing pre-1968 economic reforms, purging the Party, and otherwise resurrecting the old system.[50]

Even after 1985, the Czechoslovakian party leadership resisted extensive change. Where the Polish and Hungarian parties were far ahead of the Soviet leadership on questions of economic and political liberalization, the Czechs remained in lock step – or even slightly behind – their socialist brethren to the East. Under pressure from the USSR, they did loosen regulations on joint ventures in 1988, but they did not fully legalize private business until 1990.[51] Nor did they copy Gorbachev's *glasnost* in the civic arena, such that even in 1989 there was no opposition force strong enough to overthrow the old regime on its own. Only the revolutions in Poland and Hungary, which demonstrated the absence of a Soviet threat, pushed the Czechoslovakian rulers out of power.[52]

It is also important to note that the economic situation in Czechoslovakia in 1989 was much less dire than in Hungary or the Soviet Union. International indebtedness was low, and macroeconomic conditions were not nearly so out of balance as elsewhere in the eastern bloc.[53] In such an environment, pressure to engage in reform for reform's sake was less severe than in other post-communist countries. In this way, the post-communist government in Czechoslovakia inherited a state that was quite strong vis-à-vis other potential interests in society.