Privatisation and Corruption in Russia

Alan Rousso

Senior Counsellor
European Bank for Reconstruction and Development
Roussoa@ebrd.com

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Introduction

There is a fierce debate among rival camps over Russia's privatisation programme, much of which is centred on whether the right decisions were taken by the early reformers (with a good deal of advice from Western consultants) regarding the size, design, and pace of the programme, and whether the programme succeeded or failed (Stiglitz, Ellerman, Nellis, Black et.al, Boycko, Schliefer, and Vishny, Aslund). Happily, it is not my task to weigh in on these questions. Rather, my presentation will focus more narrowly on the question of whether and where the privatisation process in Russia contributed to the country's very serious corruption problem, and on this issue there is a vast amount of commentary but very little systematic research.

Russia currently ranks 79th out of 91 countries in the TI Corruption Perceptions Index (TI 2001). The sources of that perceived corruption are varied and go back well into the Soviet and pre-Soviet periods (many of us can recall from the history books the reported exchange between Tsar Nicolas I and his son, probably apocryphal, in which Nicolas tells the tsarevich: "You and I are the only ones in Russia who do not steal," whereupon the son replies: "Yes, father, but that is because we own everything.")

This highlights an obvious but easily overlooked point: corruption was inherent in many of Russia's past institutions, and may have been exacerbated but was not necessarily brought on by post-Soviet era privatisation. Indeed, privatisation was one of many reforms introduced in Russia designed to *improve* governance in a state already weak and unable to provide effectively the institutional infrastructure of a well-functioning market economy. What was ultimately learned was that reforms, especially privatisation, are only likely to improve governance when the state is less subject to capture by private interests (EBRD Transition Report 1999, World Bank 2001). In the end, Russia's experience with privatisation badly damaged the state's national and international reputation. Since the dark days of the Russian financial crisis in 1998 and the Bank of New York money-laundering scandal in the summer of 1999, there has been a strong tendency among casual observers and experts alike to refer to Russia in the most pejorative terms – as a kleptocracy, a criminalised state, bandit capitalism. In Russia too, privatisation has a bad reputation, where locals tended to refer to the great sell-off as *prikhvatizatsiya*, meaning the great grab.

In this presentation I will try to separate out the specific corruption problems raised by privatisation. Within the given time frame for my presentation this will not be a tour d'horizon but rather a highlight film of privatisation and corruption in Russia in the past decade. I hope it will stimulate some responses and questions that can be taken up in the discussion period.

Defining Corruption

Corruption here is considered broadly, somewhat more broadly than the World Bank definition which thinks of corruption as *"the abuse of official power for private gain."* Our definition of corruption entails *"any abuse of authority by an appointed or elected agent for private gain, or any attempt to cause such abuse."*

Because the EBRD works primarily in the private sector as a project finance bank, we have adopted a definition of corruption that encompasses not just official or state-level corruption but also intra-firm or "private corruption." Private corruption entails the abuse of private position – as in a firm's management, key shareholders, or Board of Directors – for private gain and at the expense of other stakeholders in the firm. Abuse of stakeholder rights, typically considered under the heading of "corporate governance," is a form of corruption that is of great concern to the EBRD and is directly connected to the way in which privatisation was introduced in Russia.

<u>Privatisation in Russia: Not Whether but When and How</u>

For Russia, as for all transition countries, privatisation was both unavoidable and essential to further the transition to a functioning market economy. The main questions, which had both political and economic implications, were when to start privatisation and how to execute it. The timing and approaches they chose had clear implications for the level of corruption characterising state-firm relations.

In Russia, as in many other transition countries, the decision to privatise was unavoidable and essential due to the economic collapse in the country, the breakdown of discipline of the old system, and the absence of new institutions to replace it. If Russia's new leaders did not get control over the redistribution of assets in the economy through a formal privatisation programme, there was a danger that all property would be re-allocated under the particularly corrupt form of "spontaneous privatisation" that was taking place across the country.

The **key problem**, however, was that privatisation entailed a large-scale redistribution of property from state to private interests at a time when the institutions needed to ensure that transactions are fair and transparent were fundamentally lacking. That left decision-makers with some hard choices to make over the type of privatisation programme they should adopt, all of which contained some risk of fuelling corruption.

In a 1997 paper by Dani Kaufmann and Paul Siegelbaum titled "Privatization and Corruption in the Transition," the authors unbundle this problem by looking at the ways in which different approaches to privatisation entail different incentives or disincentives to engage in corrupt practices (Kaufmann and Siegelbaum). If corruption, as they argue, is associated with the extent of control rights over economic activity exercised by politicians and bureaucrats and the degree to which cash flow rights are misaligned with control rights, then the process of privatisation can give rise to corruption through lingering (or newly acquired) control rights which allow politicians and bureaucrats to block or direct privatisation transactions.[1] The factors that are most likely to influence the prevalence of corruption in privatisation are (1) Speed – faster is better; (2) level of administrative discretion – less is more; (3) transparency – the more information the better; and (4) independent administration – the more independent, the less corrupt.

On this basis, the authors devise a typology of privatisation methods and their corruption potential:

[1] The approach is borrowed from the literature on contracting developed first by Grossman and Hart and applied to the case of privatisation in Russia by Boycko, Schliefer and Vishny.

- **Voucher-based mass privatisation**, they claim, has the lowest potential for severe corruption in its implementation because transactions are completed relatively quickly, the volume of transactions requires clearly specified rules and procedures which limits administrative discretion to firms going through the auction process, information about the process (but not necessarily the enterprises) is widely available, and they are always administered by independent, specialised agencies.

- **Tenders and trade sales** tend to be slow and open to administrative discretion, but usually entail the use of a specialised agency which improves monitoring and transfers control away from politicians, and the tendering process usually requires that information is made public. However the "level of corruption in these transactions is more a function of country-specific characteristics than the result of the inherent nature of the approach." Where natural monopolies or access to valuable natural resources are being sold, the pressures to distort the process can be great; alternatively, when foreign investors are involved, a greater degree of expertise, experience, and transparency can be brought to tender and trade sale transactions.

- **Spontaneous privatisation** represents "the very essence of corruption" being outright theft of public assets by politicians and/or enterprise directors associated with the nomenklatura.

All these methods were present in the Russian case and can now be looked at in somewhat more detail.

Privatisation and Corruption in Russia: The Evidence

Spontaneous privatisation

- In 1991, Gorbachev forced through a law that removed power of Soviet cabinet ministries over individual general directors of thousands of enterprises. The idea was to retain state ownership but give enterprise directors more autonomy.

- With the Soviet Union in a state of near collapse and the economy in free fall, this gave enterprise directors carte blanche to do as they pleased, including treating the property of the state as their personal property.

- Spontaneous privatisation gave enterprise directors the opportunity to earn enormous rents by selling the company's output domestically at controlled prices -- usually to a daughter or front company or to a friend or relative -- and then turn around and sell the same items at world prices on international markets (Blasi).

- When price liberalisation was introduced in early 1992, it exacerbated the problem of rent-seeking witnessed during this early stage of spontaneous privatisation.

- On January 2, 1992, the Russian government stopped controlling 80% of wholesale prices and 90% of retail prices. Importantly, it continued to set prices for some of the most valuable "strategic" resources such as oil, natural gas, minerals, and timber.

- Legally, individuals had the right to establish private enterprises and citizens could engage in any kind of trade and purchasing activities without permission. Foreign trade controls were also relaxed.

- The liberalisation of prices quickly helped the restocking of store shelves across Russia, as the reformers expected. It had two further less salutary consequences: first, it triggered rapid inflation, wiped out the savings of millions of Russians almost overnight, and drastically undercut support for reforms among the public [Although Gaidar had promised that liberalisation would lead to price increases no more than threefold, by year's end they went up 20-fold. Moreover, Gaidar had assumed he could keep the Central Bank from printing rubles and offering cheap credits, even though the Central Bank answered not to the government but to the Soviet era Supreme Soviet, and he assumed he could keep his own government from further subsidising powerful industries. He was wrong on all counts.]

- The second lasting consequence of price liberalisation was that it helped create the class of superwealthy "oligarchs" in Russia, who used the opportunity given them by artificial pricing to earn fantastic rents. In 1992, as Anders Aslund has famously observed, the price of a pack of Marlboro cigarettes (about $1) was the same as the state set price for 3 tons of crude oil (1/3000 of the world market price at the time). People with access to national reserves of oil, gas, timber, and precious metals made fortunes buying these goods at domestic prices and selling them at world prices (Aslund). The people who had the access are now household names in Russia: Khodorkovsky, Potanin, Berezovsky.

- The new elite quickly set up pocket banks to store their cash, and these banks were then asked to handle federal budget money on behalf of the government, in the absence of a proper treasury. Khodorkovsky's Menatep was one of these banks; Potanin's Uneximbank was another. The Moscow city administration tapped its own bank, Gusinsky's Most Bank, to handle municipal accounts. Banks holding government funds earned handsome fees and paid minimal interest at a time when inflation was in the triple digits (Black, et.al.).

- "To become a millionaire in our country," Peter Aven, head of Alfa Bank, said at the time, "it is not at all necessary to have a good head or specialised knowledge. Often it is enough to have active support in the government, the parliament, local power structures and law enforcement agencies. One fine day your insignificant bank is authorised to conduct operations with budgetary funds. Or quotas are generously allotted…for the export of oil, timber, and gas. In other words, you are appointed a millionaire." Aven was Gaidar's foreign trade minister (quoted in Black, et.al.).

- Khodorkovsky once told an interviewer that "politics is Russia's most profitable business." Khodorkovsky was a top government advisor.

- Potanin described Uneximbank as "a private bank with a state mentality." Potanin served as deputy PM and finance minister (quoted in Bivens and Bernstein).

- This is an important part of the story, because it shows the context in which privatisation took place in Russia. It indicates that contrary to popular wisdom, privatisation alone did not create the wealthy class of oligarchs that so dominated the economic and political scene in the 1990s. And it suggests that in an already questionable environment, hopes that privatisation might save Russia and its faltering economy were probably misplaced.

- Spontaneous privatisation was associated with a significant amount of private corruption, administrative corruption, and laid the groundwork for state capture. It was also a key motivation for formalising privatisation in 1992, as Boris Yeltsin himself said: "Bribery, privatisation for the sake of and by nomenklatura, the plunder of natural resources, and nomenklatura separatism threaten the disintegration of Russia."

Mass Privatisation -- *the programme*

- Russia's experience with mass privatisation is well documented, so I won't try to do more here than briefly characterise the programme and then touch upon the potential it raised for corrupt practices both during implementation and in the post privatisation phase (BVN, Blasi).

- Russia's privatisers, principally its leader and champion Anatoly Chubais (deputy PM and head of *Goskomimushchestvo*, or GKI), believed that the key to improving economic efficiency at Russian enterprises was to sever the links between enterprise managers on the one hand and politicians and bureaucrats on the other. Political control over economic activity, the hallmark of the Stalinist command economy, had to be shattered.

- Not only that, but it had to be done quickly (before the window of political opportunity closed), it had be done astutely (in order to coopt competing interest groups and get legislative support), it had to be done simply (since the task was huge and bureaucracy weak), it had to be done voluntarily (it wouldn't fly if citizens didn't actively participate), and it had to be done cheaply (shares in enterprises would have to be given away or sold very cheaply since ordinary citizens were too cash poor to participate otherwise).

- On June 11, 1992 the Russian parliament (a holdover from the Soviet period) passed the law on privatisation. The privatisers settled on a scheme to issue vouchers worth 10,000 rubles each to every Russian citizen, who could then exchange them for shares in a diverse array of enterprises.

- The Gaidar team initially favoured a programme to give 25% of enterprise shares (in preferred, non-voting stock) directly to employees. Workers could purchase another 15% at a discounted or nominal price, and 60% would be sold at auction.

- Managers, organised into the powerful Union of Industrialists and Entrepreneurs and its political arm Civic Union, were unhappy with the plan which they argued would allow black marketeers, the mafia, and foreigners to take over. They pressed for a second option whereby 51% of shares were sold to workers and 49%

sold at auction. Workers paid 1.7 times book value for the shares, generally considered quite low even for the unhealthy assets available at the time.

- A third option was also made available which allowed for manager buyouts by a group that promised to restructure the firm.

- In the end, 25% of Russian enterprises chose Option 1, 73% chose Option 2, and 2% went for Option 3.

- When voucher privatisation was over in 1994, more than 15,000 large and mid-sized enterprises had been privatised, and 41 new owners were created.

Mass privatisation -- corruption and implementation

- Kaufmann and Siegelbaum argue that voucher privatisation is potentially among the least corruption prone methods of transferring state property to private hands. In the Russian case, however, political compromises and regional deviations from the prescribed norm allowed corrupt practices to creep in.

- The process of mass privatisation was consciously designed to smash the very source of inefficiency and corruption in the Russian economy -- political control over economic activity. The goal was to remove all authority from the ministries and to create a new owning class that would, eventually, focus attention on efficient allocation of resources and maximising profit. But problems prevented full realisation of these worthwhile goals.

- The government was dissatisfied with the pressure to add Option 2 to the programme, and despite the disincentives they tried to put in place to limit its attractiveness, officials were very unhappy that in the end 73% of the firms chose to go this route. As Gaidar later lamented: “I cannot say we are satisfied with the scheme adopted by the my government, as 2/3 of the privatised enterprises are controlled by workers groups. This scheme was forced on us as a compromise.” (McFaul)

- Officials at GKI also worried openly about the use of networks, bribes, and local influence to secure special deals with the government of some kind. Reportedly, 1,000 firms cut such deals.

- Because vouchers were tradable, managers saw opportunities to increase their stakes by purchasing vouchers on the open market, using funds they “borrowed” from the company. They accumulated further control after voucher auctions by coercing employees to sell their shares.

- Managers also sought to manipulate auction proceedings to maximise the share-to-voucher ratio (the fewer vouchers were bid for the company’s shares, the more shares would be distributed per voucher). They did this by making auction locations hard to reach or announcing auctions at the last minute. In a few cases, armed guards prevented unwanted bidders from entering the auction hall.

- There were also claims that the privatisation process has helped feed the process of criminalisation in Russian society. Analysts point to participation of organised crime in voucher fraud -- printing millions of extra vouchers illegally; deliberate failure to cancel used vouchers; auction rigging and use of intimidation to scare off potential bidders. The same investigations have turned up evidence of corruption in the creation of voucher funds which defrauded shareholders while enriching a small band of scam artists. The infamous case of the MMM pyramid scheme is but one example. The government estimated that there were 2,000 unlicensed investment companies active during 1993-94, taking money from more than 80 million Russians.

- But it was the exemptions that turned out to be the most controversial aspect of voucher privatisation. Most oil, metals, natural gas, gold, and diamond mines were kept off the block. One such exception was Gazprom, the giant gas monopoly. Gazprom was privatised "privately" -- participation was restricted to individual investors, excluding both foreign and professional buyers. As a result, the company came out of the voucher auction with a valuation under $288 million, roughly 1/1000 of the value put on the company by foreign investment banks (Bivens and Bernstein).

- In 1995, Boris Fyodorov, at one time Finance Minister and Tax Minister in the Yeltsin years, described Gazprom's privatisation as “the biggest robbery of the century, perhaps of human history.” Fyodorov described the scheme as one where top management insiders received 1-5% of company stock (which he claimed was equivalent to “minimum of from $1.2 - $10 billion each”). The Prime Minister at the time was Viktor Chernomyrdin, former fuel and energy minister and co-founder of Gazprom when the Soviet Union collapsed (Bivens and Bernstein).

Mass privatisation -- corruption in the post privatisation phase

- At the time of mass privatisation, the framers knew that Russia had a weak legal and institutional framework for privatisation. Commercial and capital markets law didn’t exist when voucher privatisation was completed in 1994. Basic institutions to enforce good behaviour by company managers and controlling shareholders didn't exist. A Securities Commission was only created in 1994 and this in name only. Russia didn't have trained accountants to ensure accurate financial disclosure. Russia had a highly imperfect court system and police force combined with a culture of law avoidance. In the end, enterprise managers learned that they could plunder their firms -- rather than add value to them as privatisers hoped -- with little to no risk of persecution (Black, et.al, McFaul).

- The persistent problem after privatisation was complete was the separation of control and cash flow rights, as managers continued to hold both while shareholders had only cash flow rights. Government authorities never really took the necessary steps to ensure effective corporate governance by transferring control rights from managers to outside shareholders. The privatisers reasoned, alternatively, that wresting control from politicians was more important than wresting control from managers, which would have to come later.

- Problems inhered in all traditional aspects of corporate governance:

- independence of shareholder registers: managers would keep the registers closely guarded and refuse to register new owners they didn't like. Employees had to seek management approval before transactions were completed, opening the door to intimidation or forced sales to other insiders. A general director might refuse to reveal names of current owners in the register to outsiders trying to gain a controlling stake in the company.
- financial disclosure: no financial information was available for the thousands of firms made public by privatisation. Most companies were not audited by an independent accounting firm, so there were limited means to judge the accuracy of what was disclosed.
- democratic boards of directors: although outsiders owned 21% of the stock of the average firm in 1993-94, they were denied seats on the Board of Directors.
- fair issuance of new shares: managers used new share issues not to raise needed capital but to dilute holdings of other share owners. They would issue new shares to managers and employees but charge only a minimal price (Blasi)

- The problem of poor corporate governance was compounded at the regional level, where asset-stripping can be seen as a consequence of interactions between insiders and regional governments -- the former had few incentives to add value to firms in an atmosphere of prevailing uncertainty and an unhealthy investment climate, while the latter imposed distortions on enterprises in order to protect local employment. The implicit bargain -- whereby managers did not seek value-maximising restructuring and regional governments gave tax breaks (by collecting revenues in kind) and protected insiders from takeover attempts -- constituted a specific and distorted type of property rights regime in the regions that perpetuated inefficiency and corruption (Goldberg and Desai).

Loans-for-Shares Privatisation

- In 1995, the Russian government was having a hard time paying its bills thanks to notoriously low levels of tax collection, the war in Chechnya, and heavy subsidies to failing industries. With a presidential election in the offing, the head of Uneximbank, Vladimir Potanin, proposed to the government that he had some of his banker friends loan funds to the cash-strapped government, with repayment secured by the government's majority stake in key strategic industries that had been excluded from voucher privatisation (Freeland)

- The government auctioned control over its shares in lucrative metals, oil, and other companies in return for the loans, giving the shares as security to whomever lent it the most money.

- The process was inefficient and non-transparent in a number of ways. First, foreigners were barred from participating, illustrating that this was to be, as Boris Fyodorov put it, a case of “the oligarchs splitting up companies among old friends.” Second, the right to manage the auctions was parcelled out among the major banks, who managed to win the auctions they were appointed to manage with bids at or just above the minimum. Third, the bidding was rigged by having affiliates of the bank organising the auction submit “rival” bids and excluding bids on “technical grounds.” (Bivens and Bernstein).

- In the end, some of Russia's most valuable companies were auctioned off to political insiders at knock-down prices:

  - a 40% stake in Surgutneftegaz, company with annual oil output equal to France's Total, was purchased by Surgut itself for $88 million.
  - the auction for Norilsk Nickel, which was selling a 38% stake, was handled by Uneximbank which itself was submitting a bid. Unexim won with a bid of $170 million, only $100,000 over the government's minimum bid.
  - 51% of Sidanko was auctioned off to an affiliate of Uneximbank, which organised the auction, for $130 million. The winner paid the equivalent of 2 cents per barrel for Sidanko's known reserves, when the going rate for international reserves was $4-5 per barrel. Two years later, BP paid 4 times that amount for a 10% stake in the company.
  - 5% of Lukoil was sold to Lukoil affiliates for $250.01 million, $10,000 over the minimum bid. Weeks earlier, Arco had paid more than seven times that for a comparable Lukoil stake.
  - 78% of Yukos, Russia's second largest oil company, went to the auction organiser Bank Menatep, which bid $309.1 million, $9 million over the minimum.
  - a consortium believed to represent Boris Berezovsky won 51% of Sibneft, Russia's seventh largest oil company, for $100.3 million, $300,000 over the minimum bid (Bivens and Bernstein, Black, et.al., Freeland).

- By putting business in private hands and removing control rights from politicians and bureaucrats, privatisers argued, they were removing a key source of inefficiency and creating incentives for better standards of corporate governance. Private businessmen, even if they came into their wealth and ownership stakes in illegitimate ways, would seek to maximise profit, use resources more efficiently, and restructure their enterprises. However, for many years following privatisation, there was a greater tendency toward asset stripping and insider-dealing than restructuring and good corporate governance (Black, et.al.)

- Loans-for-shares had another important component that should not be overlooked -- it was not just a give-away of state property, it was a trade of state property for political support. An election was coming up in 1996, and Yeltsin was increasingly unpopular and in need of financial and political support from the people who controlled the country's wealth and media. As Gaidar told one journalist: “I understood the loans-for-shares programme perfectly well. Loans-for-shares created a political pact. They helped ensure that Zyuganov did not come to the Kremlin. It was a necessary pact.” (Freeland)

- Of course, the political impact was not all positive, even from the government's point of view and it was not a one-off. First, loans-for-shares helped secure a communist victory in the parliamentary elections of 1995 where the KPRF took 23% of the vote and wound up blocking most of the government's later reform plans. And second, loans-for-shares solidified the emergence of the oligarchs, whose influence lasted well beyond the 1996 election (which Yeltsin of course won with the bankers' help), and sealed Russia's fate as a high capture country that was slow to reform.

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