PRIVATIZATION REFORMS REVISITED – DOES 'RULE OF LAW' MATTER?

A COMPARATIVE ANALYSIS OF POLAND AND RUSSIA

by

KARDAM TOTEV

(Under the Direction of Christopher S. Allen)

ABSTRACT

This thesis is motivated by the puzzling observation that the neo-liberal assumption about the crucial importance of a speedy privatization process for economic performance is not confirmed by real-world events in Poland and Russia. While Poland chose a less radical, more gradual path of ownership transformation than Russia, the results of Polish privatization were clearly more favorable. Two competing but not mutually excluding explanations are examined – rule of law and privatization method. While the latter is found to be rightly referred to as one important determinant of privatization success, the former, in the past often neglected explanation, appears to be also important for clarifying the question why rapid privatization in Russia yielded worse results than cautious privatization in Poland.

INDEX WORDS: Economic transition, privatization, institutions, rule of law, privatization method, Poland, Russia

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KARDAM TOTEV

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KARDAM TOTEV

Major Professor: Christopher S. Allen

Committee: Markus M. L. Crepaz
Gary Bertsch

Electronic Version Approved:

Maureen Grasso
Dean of the Graduate School
The University of Georgia
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DEDICATION

For

My Beloved Grandparents

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TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

CHAPTER 1

INTRODUCTION

After the demise of the system of a centrally planned economy, former socialist Eastern European countries entered a process of profound economic transformation. Seeking to catch up with the highly developed countries of Western Europe, many transition countries looked at the West as a blueprint for successful economic development. There was a general common understanding on both sides, East and West, that the system of a planned economy needed to be replaced by a market economy. From this goal different reform measures were derived based on a series of tenets which today is referred to as the "Washington Consensus" (see e.g. Kolodko 1997, Williamson 1990 & 1997). The donor community linked economic assistance to the implementation of certain reform measures which were supposed to liberalize the economy. Economic recommendations were based on a 'one size fits all' approach. A very central reform measure was privatization. Early, quick and radical privatization by itself was expected to lead to rapid increase in economic performance. Some refer to proponents of this view as 'shock therapists'.

For the purpose of this thesis, privatization shall be defined in a somewhat more narrow (but common) sense as the transformation of ownership of existing economic entities from the state to the private sector, excluding the satisfaction of restitution claims. Restitution is excluded from this definition because returning property that had been expropriated decades earlier is qualitatively different from privatizing later created firms as the latter is a result of policy choice whereas the first should not be subject to much fundamental discussion and policy discretion if a country pretends to be democratic and to acknowledge rightful demands of formerly expropriated citizens and their successors. Therefore, privatization through restitution is beyond the scope of this thesis and not examined. Thus, the concept 'privatization' in this thesis does not stand for the overall privatizing of the economy but for the transformation of ownership of existing economic entities. The period considered begins with the start of the privatization process in 1991 and ends in 1995.

The purpose of this thesis is not to examine the usefulness of privatization itself. The former socialist transition countries are characterized by the fact that they all had a command economy with almost all factors of production being in the hands of the "collective", and thus an overwhelming share of the domestic product being generated by state-owned firms[1]. If one of the transition objectives is to truly break with the socialist past and to abandon the idea that the state must control the *whole* economy then the new political leadership may consider it insufficient to merely allow private ownership of production resources, but the state may also choose to actively decrease its economic activity by selling assets to private owners, thus allowing and accelerating the process of the private sector to regain its control over part of the national economy. This does, of course, *not* mean that transition toward a market economy must naturally result into eliminating the public sector. The question of if and how much the state should 'pull out' from the economy is a policy choice that each country needs to make individually. In his influential book *The Great Transformation,* Polanyi (1957) suggests that any move of a country toward more market is an explicit policy choice, not a consequence of natural order. What might be good for one country is not necessarily good for another (see e.g. Kurth 1979).

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[1] It shall be noted that there were clear differences in degree among the different socialist countries: Poland, for example, never collectivized its agriculture.

Western capitalist countries show a high degree of variety of capitalism with Continental European countries like Germany, France and Sweden where the state has an important stake in the economy as opposed to the Anglo-Saxon model which historically emphasizes more economic liberalism and a 'small state'. Germany's dominant model of post-war development, for example, was neither too much emphasis on 'laissez-faire', nor on Keynesianism. Instead, Germany relied in particularly on providing a stable general framework as the basis for free competition and a strong self-regulating private sector (see Allen 1989).

Looking at countries that are characterized by a socialist legacy, there are also different models of development. China, for example, introduced some principles of a market economy while keeping control over the state assets. In contrast, Poland and Russia, like most other European transition countries, chose a more decisive break with the socialist past in the sense that both entered the path of privatization.

Privatization is not an objective in itself. It is a mean to achieve certain goals among which are productivity increase and overall prosperity. Sometimes, however, the call for privatization reforms appears to be based on ideological beliefs rather than pure rational and utility-maximizing considerations. For example, in the case of Thatcher's privatization in Great Britain, it seems that privatization was more a policy in search of a rationale rather than the other way around (see Zahariadis 1995).

In principle, the transformation of ownership from the state to the private sector can yield positive economic outcomes. Referring to Megginson and Netter (2001) the most important theoretical arguments in favor of privatization shall be mentioned briefly: First, there is the problem of defining goals of state owned firms because governments have many objectives other than maximization of profit and value added. Furthermore, even with clearly defined firm objectives, monitoring of goal implementation is suboptimal because of the diffuse nature of the owners of the public firm (the citizens). Second, governments will tend to intervene less in private firms' operations due to higher transaction costs. Third, inefficient public firms are often allowed to rely on government subsidizing which has negative consequences for the state budget and destroys value. Fourth, besides the subsidies that are being saved, privatization has other important fiscal implications as additional income is generated through the company sales which can, for example, be used for investments in key areas for the future development such as education and infrastructure or for the reduction of the debt burden. Fifth, and very importantly, privatization can help develop more efficient product and security markets and thus contribute toward a competitive environment.

A vast amount of literature discusses the theory of privatization and generally points out the positive macro- and microeconomic effects private ownership of factors of production has compared to state ownership (see for example Shleifer & Vishny 1996, Shapiro & Willig 1990, Vickers & Yarrow 1990, Laffont 1993, Blanchard 1997). Most of the empirical analyses comparing public versus private ownership in non-transition countries also support this view and conclude that private firms are more profitable than SOEs (see for example Vining & Boardman 1992, Dewenter & Malatesta 2000).

Similar conclusions are made in the majority of empirical studies that compare pre- and post-privatization corporate performance: These studies generally agree that sales, efficiency, profitability and capital investment spending have increased significantly after privatization. They differ, however, on the question whether privatization has had positive or negative effects on employment (see for example D'Souza & Megginson 1999, Megginson, Nash & van Randenborgh 1994, Boubakri & Cosset 1998, Dewenter and Malatesta 2000).

Thus, the topic about the usefulness of privatization has been discussed extensively elsewhere. There appears to be much evidence that supports the assumption that, *in principle*, privatization *may* yield positive outcomes in terms of efficiency, profitability and additional value creation which could potentially benefit society and improve welfare. Building on this assumption, this thesis wants to contribute a small piece to answering the question of *how* privatization can yield better results. Thus, the purpose of this thesis is not to ask for the "If" of privatization reforms but for the "How".

Institutions, in particularly the rule of law, are expected to be crucial for successful privatization. A central purpose of this thesis is therefore to examine whether the view is justified that the role of the rule of law in the privatization process deserves more attention in scientific research as well as in policy-making.

The Puzzle

Countries differ in both how early they implemented privatization reform measures and how rapidly they proceeded towards completion. Contrary to expectations formulated in the Washington Consensus, not all countries that privatized early and rapidly did perform economically successful. Russia is such an example. Between 1992 and 1994, very soon after the break-up of the Soviet Union and the demise of communism, Russia undertook a radical privatization program. By 1995 the shares of two thirds of all Russian large and medium firms were partially or entirely transferred to private hands and 80 per cent of the small state-owned firms were privatized. Of the 76,000 privatizations under the mass privatization plan, 70 per cent were majority sales (> 51 per cent) giving the main control to the buyers, very often "insiders" (see Broadman 2001). With this speed of privatization, to the surprise of Western observers, Russia closed the gap and even surpassed Poland in terms of privatization progress. The slightly higher private sector 1995 share of GDP in Poland (ca. 60 per cent) in comparison with Russia (ca. 55 per cent) is misleading as a proxy for privatization progress because much of Poland's private sector growth was not due to the privatized firms but to the *de novo* private enterprises whereas in Russia the newly emerging private enterprises contributed much less to the development of Russia's private sector (EBRD Transition Report 2000). In Russia, the largest part of private sector expansion was due to transformation of ownership. The privatization process was seen by some as the single most important element in the Russian reform program (see for example comment of Stanley Fischer in Boycko et al. 1993). In contrast, Poland chose a slower pace of privatization, even against criticism from Western advisors and transnational institutions. Neo-liberal theory which underpinned the Washington Consensus would predict that the privatization process in Russia yielded more successful outcomes than in Poland because it was faster and more radical.

However, the results in terms of performance of the privatized firms and overall economic development were opposite of expectations. For Poland and Russia, the expectations of the Washington Consensus never materialized. A number of studies have examined the microeconomic effect of privatization. The picture that emerges is different for Poland and Russia. The Polish privatization process is generally found to have had very positive results on corporate performance and restructuring efforts (see e.g. Frydman et al. 1997, Blaszczyk et al. 2004). In the case of Russia, the effect of privatization is mostly found to be either weak or none at all. Numerous studies find that in Russia ownership and corporate performance are not well correlated (see e.g. Estrin et al. 1999, Bevan et al. 2001, Blaszczyk et al. 2004). Djankov et al. (2000) and Djankov et al. (2000b) survey a large amount of analyses and find that privatization had very different outcomes among transition countries, namely, the effect was significantly more positive for non-CIS countries than for CIS countries[2]. According to Black et al. (2003), Russian privatized firms were not significantly more productive than their state-owned counterparts, even by the end of 2000.

The positive effect of privatization in Poland is also documented by significantly higher investment spending of privatized firms. Polish privatized companies reinvested 10 per cent to 30 per cent of annual sales as opposed to SOEs which invested only 1 per cent to 3 per cent (see Blaszczyk 1999). According to Blaszczyk et al. (2004) privatization in Russia did not result in any significant corporate investments. Indeed, as shall be shown later, Russian privatized firms were often divested for private gains and the increase in capital stock was partly even negative. On the whole, the microeconomic outcomes of (gradual) privatization in Poland were clearly more favorable than the outcomes of (rapid) privatization in Russia.

In contrast to other studies that define their dependent variable 'privatization success' only in terms of microeconomic indicators such as the ones mentioned above, it is argued here that privatization success must be seen in a larger context. It is not enough to simply look at corporate statistics and not to ask what the effects of privatization are for the national economy and society as a whole. The following two examples may briefly illustrate this point: First, productivity of privatized firms may rise but if there is no newly emerging private sector to compensate for restructuring measures because the privatized firms defend their monopoly position, then privatization may have adverse economic and social consequences. Second, the increase in corporate profits is generally a good sign, but if this increase is based on a market-

[2] There is no indication that the outcomes in Djankov et al. for the two groups (CIS versus Non-CIS) are not also true for the two countries individually. All the more that Poland and Russia are each by far the largest country within the respective group and are never specifically referred to as outliers within the group.

dominating position of the privatized company or on low profit reinvestment rates endangering the firm's long-term success potential, the effects for society may be adverse. These are only two of many possible examples that argue in favor of considering *both* the micro- *and* the macroeconomic level when examining privatization success. Excluding the macroeconomic dimension risks missing the important point that privatization is above all supposed to increase overall economic growth and welfare. Microeconomic restructuring and efficiency gains are more a good way of achieving this overall goal and less an objective in itself. Therefore, this paper also considers possible effects of privatization on the macroeconomic situation. Obviously, macroeconomic success is also dependent on factors that are not connected to privatization and in a quantitative study including the macroeconomic dimension into the dependent variable may be problematic. The format of a qualitative study, however, allows tracing back certain effects of (bad) privatization on macroeconomic development that are often ignored by empirical studies which focus merely on microeconomic outcomes. Thus, the dependent variable 'privatization success', which is defined later, is operationalized by indicators that relate to both micro- *and* macroeconomic development.

On a macroeconomic level, out of all former socialist transition countries, in 1996/1997 Poland first achieved output levels from before the transition (World Economic Outlook database 2001). While in the three year period between 1996 and 1998 Russia's domestic product decreased on average by about 2.5 per cent annually, Poland's GDP grew on average by roughly 6 per cent annually (see Table 1.1).

Table 1.1: Growth of the gross domestic product (GDP)

GDP growth in %	1996	1997	1998
Poland	6	6.8	4.8
Russian Federation	-3.4	0.9	-4.9

Source: Global Development Finance & World Development Indicators

Income inequality in Russia was significantly higher compared to Poland. According to Black et al. (2003), for 1996-1998 the Gini index in Poland was 33 whereas in Russia it amounted to 47. This means that the economic decline in Russia had especially severe consequences on the poorest. Poland's living standards in 1999 were 20 per cent higher compared to 1989 (Global Investing News) whereas Russia's living standards are below pre-transition levels even today.

In the EIU global business ranking model which assesses 70 indicators in order to measure the quality of the business environment in sixty countries for the past five years (as well as the next five), the Economist Intelligence Unit ranked Poland 31st for the period 1996-2000 (The World Bank/The William Davidson Institute 2001). The score of 6.22 equaled a qualitative assessment of the Polish business environment as "moderate"[3]. Russia was ranked only 53rd with a score of 4.12 which corresponded to the qualitative grade "very poor". Accordingly, the foreign direct investment (FDI) in Russia was significantly lower than in Poland (see Table 1.2). While Poland's FDI amounted on average to 3.6 per cent of GDP for the regarded period, the same number for Russia was only 1 per cent. Poland was regarded as an attractive location for investment and as one of the world's most promising emerging markets (see Belka 2000).

[3] with the next higher assessment "good" being assigned to a slightly higher score of 6.5

Table 1.2: Foreign Direct Investment (FDI) as a share of GDP

FDI as share of GDP in %	1996	1997	1998
Poland	3.4	3.3	4.0
Russian Federation	0.6	1.5	1.0

Source: Global Development Finance & World Development Indicators

Of course, like most transition countries, Poland had and still has a number of economic problems. Some industries are still unproductive, Poland's agrarian sector is uncompetitive and unemployment is higher than in some other transition countries. Nevertheless, in perspective, Poland's post-socialist economic development and in particular its privatization program is regarded as a rather successful case of transformation whereas Russia's privatization process, in terms of outcome, can only be qualified as a failure.

After more than a decade of transition experience there seems thus to exist some evidence suggesting that the claim of many shock therapists that rapid privatization alone always bears the fruits of better economic performance independently from other policies and given conditions and that the faster firms are privatized the better under any circumstances, does not hold for all countries. Therefore, the radical 'one size fits all' approach appears at least questionable. The privatization process in Poland and Russia yielded results contradictory to theory. The puzzling question then is why was this the case? What might be a plausible explanation for the fact that real world developments in Poland and Russia seem to contradict important theory that was the underpinning for an agenda of radical privatization reform?

Research question

If it is not the fast speed of ownership transformation, what else explains privatization success in Poland and Russia? Are there maybe other important circumstances that must be given first before privatization can affect macro- and microeconomic performance positively in an optimal way? Does the way ownership is being transformed play a role? This thesis offers and examines two competing explanations – 'rule of law' and 'privatization method'.

Contrary to the spirit of the Washington Consensus, it is assumed that there are indeed certain circumstances that are crucial for a more successful privatization. The interaction between these circumstances and privatization are expected to determine the success of privatization. Privatization by itself may lead to favorable or unfavorable results depending on other conditions. If certain conditions are not met, rapid privatization is expected to lead to suboptimal outcomes. The logical consequence would be that in such a case the privatization process needs to be slowed down so that the necessary conditions can be created.

For the purpose of this paper, these circumstances concern primarily the degree to which the rule of law is secured. The concept of the rule of law is only a small part of the much larger concept 'institutions'. Much literature exists on institutionalism and the so called 'New institutionalism' which became popular in the early 1980s (see e.g. Lijphart 1984, North 1990, March et al. 1984, Steinmo et al. 1992). In the transition context as well as more specifically in the discussion about an optimal privatization strategy, however, this variable has been neglected. Only recently more efforts have been undertaken to examine the role of institutions in the transformation process (see e.g. Kolodko 1998, Sachs et al. 2000). In this thesis, I focus narrowly on a small fraction of the bigger discussion about institutions by examining the role of the 'rule of law' in the privatization process. A legal system of a country is a highly complex topic and many institutional elements may influence privatization success. It is beyond the possible scope of a thesis to examine *all* relevant regulatory elements conducive to better privatization outcomes. Thus, the strategy of this paper is to pick only some of them and to examine whether at least these few elements may represent important conditions for privatization success. If evidence can be found that supports the assumption for the chosen institutions, then the next question of which other institutions may be relevant is a more detailed, though important question and would justify further research in this domain. Thus, the main independent variable is the rule of law. The concept of ‘rule of law’ is operationalized by looking in particular at competition regulations, shareholder rights and anti-corruption law.

The second explanation for differences in privatization success examined in this paper is the method of ownership transformation. In contrast to institutions, privatization method has been examined extensively in the context of successful privatization.

These two explanations are competing but they are not necessarily mutually exclusive. It shall also be noted that both explanations may have important implications for the assumption of shock therapists that privatization should always be realized quickly.

The dependent variable shall be named ‘relative privatization success’. This term does explicitly *not* stand for privatization *progress*. It rather implies that privatization is considered not as an objective in itself but as a mean which is supposed to yield beneficial outcomes. The beneficial outcomes refer to better micro- and macroeconomic success. ‘Relative’ has been added to the term to signal that in this thesis privatization success is not treated in terms of an *absolute* reference point defining success and non-success. Rather, when comparing Poland and Russia, each of the two cases represents a *relative* reference point for the other one. Thus, privatization success is not defined in absolute but in relative terms.

The dependent variable ‘relative privatization success’ is operationalized by a number of different indicators: One indicator of relative privatization success is the small businesses density per thousand citizens. This indicator can be regarded as a proxy for competition intensity as more market participants also mean more competition. Increasing competition and not hindering new private sector expansion, however, is a central goal of privatization.

A second indicator of privatization success is the relative level of productivity improvements. Productivity is a major determinant of micro- and macroeconomic success. Due to lack of aggregate data, I have to rely on indirect data from secondary literature which compares productivity in Polish and Russian companies.

A third indicator for the dependent variable is looting of assets and capital of privatized firms. Stealing productive assets has direct negative micro- and macroeconomic consequences. On the microeconomic level, whatever assets are stolen from the privatized firm cannot add corporate value which means lower enterprise performance and higher risk of bankruptcy. On the macroeconomic level, the negative effects are especially strong if these assets are exported because they cannot add to domestic output and wealth increase anymore. An optimal indicator would be value of annually looted assets as a share of GDP. Unfortunately, probably because of the hidden nature of looting, I did not find such data. If one good indicator is not available then it appears to be helpful to use one alternative or a combination of other alternative (sub-) indicators as proxies instead and to examine whether they point into the same direction. One indicator proposed by Campos et al. (2002) as a proxy for looting is the share of private start-ups that exploit physical capital originating from state enterprises. The higher the share of enterprises that respond positively the higher is the probability of looting in the past. Another proxy for looting is the net fixed capital formation. The higher this indicator the lower is the probable relative degree of looting. These two sub-indicators are interesting substitutes as they look on the phenomenon from two different perspectives: The former relates to stripped assets that may have damaged the company but, at least, remained in the national economy as productive capacities. The latter attempts also to capture the external dimension – assets and capital that were not only stolen but also transferred off shore and which therefore do no longer contribute to value creation within the country. Each of the indicators has the central inconvenience that it is not solely determined by the degree of looting. If both of them, however, point into the same direction for one country relative to another country then it can reasonably be assumed that the probability that there are indeed significant differences in self-dealing for private gains among the cases is high.

A fourth indicator of privatization success is the generated privatization revenues. This indicator is different from the other three in that it makes no sense to consider 1996-1998 revenues from privatizations made in 1991-1995. As the time period of the independent variable is 1991-1995 it makes only sense to consider privatization revenues from the same period. In this case, false causal relationship can be excluded because privatization cannot be caused by revenues that have not yet been made. Thus, in this case the time period of independent and dependent variable are coinciding without that there can be any error of causality. Privatization revenues raised by 1995 are included as an indicator for privatization success because the amount raised has direct consequences for the state budget and thus short *and* long term macroeconomic performance beyond 1995. All of these indicators have in common that they are closely associated with micro- and macroeconomic performance while at the same time they are expected to be influenced by the way how privatization is being executed. Thus, differences in any of these indicators also mean differences in the relative success of privatization.

This thesis joins the effort of other papers that are part of a contemporary shift in the transition paradigm away from the Washington Consensus toward a more evolutionary view of transition that tries to take into account and to learn from more than a decade of post-communist history.

Methodology

As much as it is important in political science to think about the bigger picture and to compare a large number of transition countries with each other, the author of this thesis feels that in the discussion about transformation strategies too little attention is given to concrete events and particularities in each country. It may, however, be helpful to look at individual countries where developments are in odds with expectations in order to test hypotheses about their degree of generality and to use the insight to eventually refine these hypotheses so that they become more universal.

One such outlier is Russia. Contrary to expectations, rapid privatization there did not lead to fast economic recovery. The case of Russia is contrasted to the more successful case of Poland which although it launched reforms in a so called 'big bang' approach, later proceeded quite cautiously with the privatization process and nevertheless performed well economically.

Poland and Russia are interesting cases because despite many similarities of initial conditions the economic transformation after the political changes proceeded quite differently.

Both countries were ruled for decades under principles of socialist ideology. Thus, in both cases the main economic decision-maker and owner of productive resources was the state. Both countries had reached a comparable social and economic development. In terms of living standards measured by 1989 GNP in purchase power parity units (PPP), Russia even surpassed Poland slightly[4] (see e.g. DeMelo et al. 1997). The level of education, medical treatment, culture, urbanization and other basic development indicators were similar. There are always differences between countries due to history and culture, but on the whole with the selection of these two

[4] Poland's GNP (PPP) = $5150, Russia's GNP (PPP) = $7720. However, these numbers should be treated with caution

cases, I am following the strategy of a ‘most similar systems design’ which allows better comparison and decreases the likelihood of overlooking important factors.

I aim at testing the main hypothesis that differences in the rule of law in Poland and Russia are important for explaining differences in privatization success. The alternative hypothesis emphasizes the importance of different privatization methods. The strategy of this thesis is to build a theoretical framework in which I will present some important mechanisms through which I expect legal regulations and privatization method affect privatization success. I will then examine if in the case of Poland and Russia there is a correlation between the independent variables and the dependent variable and test whether the assumptions that these mechanisms did indeed contribute to higher economic performance in Poland compared to Russia are supported by compelling evidence. In the case of Russia, for example, I need to show that the rule of law was less developed and I need to present the actual existence of important mechanisms through which the lower level of institutional development contributed to less economic performance. I would have to reconsider the accuracy of my main hypothesis if it would either turn out that the rule of law in both countries was at a similar level or if I could not show convincingly through which mechanisms the existence or absence of effectively enforced rules increased or decreased privatization success.

Choosing the format of a (two) case study has the advantage that it is possible to trace back effects of privatization on both corporate performance and overall economic development, something that is difficult in a quantitative study because there may be too many other factors causing variation in macroeconomic performance and the resulting correlations may be highly biased. The inconvenience is that without rigorous statistical tests, effects are different to quantify and causation difficult to prove. Case studies, however, are important as a pre-supplement to quantitative studies.

The right timing of variables is methodologically important. The independent variables refer to the first half of the 1990s from the beginning of transition[5] until 1995 when an important part of privatization had already been completed and the private sector accounted for more than half of the economy in both countries. The dependent variable 'privatization success' refers to the time period 1996 to 1998. The reasons for choosing this time period are twofold: First, as I do not choose overlapping time periods I avoid the risk of wrong causal conclusions due to wrong temporal order. Second, privatization may have opposite short-term and long-term economic performance impacts (Aghion and Blanchard 1993, Roland 1994). Because of the fundamental nature of privatization, I am rather interested in medium and long term effects. Had I chosen the dependent time period to be too close to the independent time period, I would risk making (spurious) conclusions because these would be based on short-term relationships. Sometimes, I make certain assumptions about consequences of lack of enforced rules which then are tested. For the same reasons as above, in order to distinguish cause and effect, these assumptions also refer to the time period 1996 to 1998.

The thesis is structured as follows: Having presented above the purpose of this paper, the puzzle, the research question and the methodology, I will end this introductory chapter by providing a brief overview over the ongoing scientific debate about successful privatization. In the second chapter, the two hypotheses are developed. The third and fourth chapter tests each of the two hypotheses by analyzing the empirical evidence available for Poland and Russia. The last

[5] with Poland's transition starting 1989/90 and Russia's starting 1991

chapter contains a discussion of the results, a summary of the outcomes as well as suggestions for further research.

Obviously, beyond the two examined competing explanations for differences in privatization success there are other possible explanations, such as for example macroeconomic stabilization, liberalization of prices and trade, historical legacies, informal institutions, etc. Because it is not possible to examine all these factors in more depth within the same thesis, the strategy is to compare the often neglected factor 'rule of law' with one very frequently examined factor 'privatization method' as a reference point. Depending on the outcomes it should be possible to assess whether it is justified to consider the former, too, as one major possible explanation for privatization success in transition countries.

Clearly, this case study is not designed to prove that the main hypothesis is universally true for all transition countries as it examines only two of them. However, it may be possible to find convincing evidence which may help disproving the generality and universality of the hypothesis or the alternative hypotheses. At the same time it will be possible to assess whether the evidence derived from the two cases Poland and Russia supports more the main or the alternative hypothesis or both. The results may also have implications on the neo-liberal assumption about the importance of speed of privatization.

Attempting to answer the research question is important. Not only does it help to better understand the past, but it may also provide important implications for future reform policy. Most former socialist countries are still in the midst of their transformation, especially the Balkan countries as well as the countries of the Commonwealth of Independent States (CIS). The world's last two hard-line communist countries, Cuba and North Korea, may one day also enter the path of transformation toward a market economy. And even though this thesis, like much other research around this topic, concentrates exclusively on (two) former socialist countries, some insights derived may also be applicable to developing countries who share similar challenges and aspirations.

The Debate – a brief overview

After more than a decade of experience with the transition of the former socialist Eastern European and Central Asian countries, the debate about the optimal transition strategy is still ongoing. Much of the disagreement centers on the question of speed of reforms. Some argue that the speedier the reforms the more transformational success is to be expected. Proponents of the so called “shock therapy” argue that radical economic reform is more important than perfection in the detail. Reform speed should be maximized because once the political window of wide political consent toward radical reforms is closed, it may later be more difficult, if not impossible, to realize the reform measures necessary (see e.g. Joskow et al. 1993, Aslund 1995, Dabrowski 1996, De Melo et al. 1997, Sachs 1996). In contrast, advocates of the so called “gradualism” argue that maximizing the reform speed may have adverse effects. For example, it is frequently referred to the danger of shock therapy that more is being destroyed than newly created (see e.g. Murrell 1993, Kolodko 1998).

Williamson (1990 & 1993) describes a set of reform policies that he and others refer to as the “Washington Consensus”. One of the policy suggestions there in is *fast privatization*. Shock therapists argued that transition countries would achieve the best success if they privatized fast and radically. The sooner companies were privatized the sooner they could begin producing more efficiently, no matter what circumstances. Examining 76 developing countries, Aziz et al. (1997) suggested that even though the policies referred to as the Washington Consensus are “generally the right ones” (p.3), only policy complementarities would bring significant success. Individual policies would promote economic growth, but the combination of policies would appear to be especially important. However, Aziz et al. reject the notion of sequencing and instead suggest that all reform policies should be realized simultaneously. Dabrowski (1996) goes another step further and notes, in addition to the importance of policy interaction, the necessity of sequencing of reform measures. He suggests that privatization needs to be preceded by macroeconomic stability and liberalization in order for microeconomic restructuring to progress quickly. However, even with privatization a rapid transition is considered to be “less risky for restructuring and for complex institutional reform than a slow transition”. The assumption is that the market mechanisms will influence economic behavior of firms in a way beneficial for society.

Only in recent years, the discussion has begun to point out the importance of institutions. Sachs et al. (2000) examine the empirical evidence across 24 former socialist transition countries and find that change-of-title alone has not been sufficient to achieve economic performance gains. Real gains would come from combining change-of-title with the so called OBCA reforms which in addition to a legal and institutional framework (A) also include the firm’s objective function (O) and the hardness of the firm’s budget constraints (BC). Interestingly, they find that there is a threshold level of OBCA in order for change-of-title reforms to benefit economic performance. If OBCA reforms are below the threshold level, privatization may impact performance negatively. Finally, they find that change-of-title and OBCA reforms benefit various clusters of countries (EU Border States, Baltics, Balkans, Western FSU, Caucasus, Central Asia) differently which leads the authors to reject the ‘one size fits all’ policy. Similar to Sachs et al. more and more papers reject the emphasis of the Washington Consensus on speed and laissez-faire capitalism and propose institutions as one crucial element for the success of liberalization reforms such as privatization (see e.g. Nellis 1999, Stiglitz 1999, Kolodko 1998).

> *"(…) capitalism is revealed to require much more than private property; it functions because of the widespread acceptance and enforcement in an economy of fundamental rules and safeguards that make the outcomes of exchange secure, predictable, and of reasonably widespread benefit. Where such rules and safeguards, such institutions, are absent, what suffers is not just fairness and equity, but firm performance as well. Why? Because in an institutional vacuum the chances are high that no one in or around a privatized firm is interested in maintaining the long-run health of the assets."*
>
> Nellis 1999, p. 16

CHAPTER 2

DEVELOPMENT OF THE HYPOTHESES

Rule of law

According to North (1990) human interaction is characterized by pervasive uncertainty which manifests itself through transaction costs. Conventions, that are, general agreements on language, meaning and behavior, represent a useful tool for human interaction as they decrease uncertainties about the behavior of others and create expectations about the outcome of the interaction. Sometimes these conventions are so important and fundamental to a society that they become institutionalized. North defines institutions as humanly devised rules of the game in a society (p.3). They do not only structure human interactions but also enforce individual and social behavior by obliging everyone to act according to the norms. North argues persuasively that institutions by reducing uncertainty allow economies to function.

North distinguishes three dimensions of institutions: Informal institutions, such as norms and societal codes of conduct, are socially transmitted and part of the culture (p.37). Formal institutions, such as rules and laws, may increase the effectiveness of informal constraints, modify them, or supersede them (p. 46). The third dimension, enforcement, highlights the necessity for the state to have a certain degree of coercive power.

Building on North's thesis that institutions reduce uncertainty by providing and enforcing a stable structure for human interaction, I argue that institutions determine to an important extent the success of privatization. In other words, human interaction must be effectively constrained by institutions in order for privatization to be more beneficial.

Institutions, however, represent a very complex topic and therefore I focus only on one small element – the rule of law. De Soto (1989) points out the crucial importance of the rule of law for society as it, by protecting the rules of the game, facilitates socially desirable behavior.

> *[A good law] must facilitate the specialization and interdependence of individuals and resources. (…) However, this specialization of individuals and resources cannot take place if individuals are isolated and do not trust one another. (…) There can be no denying that the law, and the institutions safeguarding it, are the principal source of this trust. (…) We sincerely believe that development is possible only if efficient legal institutions are available to all citizens.*
>
> De Soto, pp. 182-186

I limit the focus further by looking only at the existence and enforcement of selected regulations that I expect to have an especially important effect on privatization success – competition regulations, shareholder rights and anti-corruption regulations. Some other elements of a regulatory framework that may be important for privatization success but are not examined because of time and space constraints are, for example: Contract enforcement, bankruptcy law, property rights as well as non-legal institutions securing a system of financial intermediation.

The three kinds of institutions are combined in the main hypothesis because they represent the same concept of 'rules of the game' assumed to be necessary if privatization is to yield positive results. Furthermore, even though the three institutional factors are distinct as they represent different facets of the same concept, multicollinearity between independent variables might be a problem if they were stated as three independent hypotheses.

My main hypothesis is that Poland's privatization process was relatively more successful than Russia's because of the higher level of 'rule of law' at the beginning and during the privatization process. Table 2.1 at the end of this chapter represents a checklist of expectations derived from the theoretical argumentation below. This checklist operationalizes the theoretical argumentation and is used in chapter 3 as the basis for testing the main hypothesis.

Competition regulations

The main hypothesis above is based on the assumptions that a functioning competitive market is crucial for privatization success and that an effective regulatory framework is a necessary institution for privatization to significantly improve and not to damage the functioning of a market. The first assumption is today widely acknowledged and difficult to reject. After all, a central argument in favor of privatization is that this kind of transformation of ownership is supposed to contribute toward the accelerated creation of a competitive market. A crucial characteristic of a well-functioning market is the degree of competition among the market participants. Competition is a driving force for a company to constantly seek increasing its productivity in order to sustain its market presence. Lack of competition drastically reduces the incentive for a company to continuously search for the best way of improving the corporate processes in order to maximize the relation of output to input. It is more likely for a company to increase its productivity if it is confronted with a situation in which the other firms represent a benchmark for critically assessing the own performance. This constant comparison with other market actors produces the awareness within the company of the necessity to constantly search for more sophistication and excellence at all levels within the firm in order to improve or, at least, keep the relative competitive position. Firms react to competition in this way because they have no other choice. If they would not seek constant improvements they would sooner or later face a situation in which the gap in relative competitiveness compared to other firms has become so large that profits turn into losses, value is being destroyed and the company has to announce bankruptcy. Thus, at an aggregate level, more competition results in more productivity and efficiency of firms. As a nation's material wealth is generated through these firms, more competition also benefits society through accelerated economic development due to faster productivity improvements.

The privatization process may affect competition in positive and negative ways: As mentioned earlier, privatization transforms economic responsibility and initiative from the government to the private entrepreneur and therefore in itself tends to increase competition intensity. This is so because once the entrepreneur's own private assets are at stake, he has compared to the government, ceteris paribus, a much higher incentive to ensure that the invested capital is used efficiently. By seeking the highest possible return on investment, the entrepreneur is on average more likely to undertake necessary steps towards productivity improvement because he is personally interested that his company is economically successful. By improving the productivity and therefore the competitiveness of the company, the entrepreneur increases pressure on other firms to do the same if they want to keep their relative position in the market. In contrast, government executives and managers of state-owned firms are usually much less personally dependent on corporate success. They are therefore likely to reach lower rates of increase in productivity and competitiveness.

However, I argue that in order for these benefits of privatization to fully materialize, it must be ensured that the competition is fair. If competition is unfair, privatization may have adverse effects on competition intensity. Unfair competition results in inefficient markets and suboptimal resource allocation which hurts not only disadvantaged market participants but also the economy as a whole. Here the second assumption about the necessity of an effective regulatory framework comes into play: The market must be protected from itself. One fundamental reason for this assertion is the following: On the cost level, economies of scale decrease the costs associated per unity of output because of the law of declining marginal unit costs. On the revenue level, facing fewer competitors means more latitude in pricing as the price equilibrium shifts in favor of the company. Both objectives, reducing costs as well increasing prices and thus revenues, point into the same direction: A general preference of enterprises to reach or at least come close to a position of monopoly within a market. Not facing constraints from a regulatory framework, companies will tend to try achieving a monopolistic or at least oligopolistic market position as this is conducive to the overall goal of maximizing profits, by minimizing unit costs via economies of scale and maximizing unit income via control over prices.

This natural tendency toward monopolization which is ingrained in the very nature of capitalist markets, however, is in stark contrast to the basic principle of efficient markets. It diminishes the efficiency of the allocation function of the market. A completely unregulated market becomes a danger to itself. In fact, as much as it concerns prices, monopolized markets mean price control only that it is not the government who controls prices but enterprises. It may be argued that the effect of monopolization and corporate price control on the economy and the living standard of the people is even more negative than state price control as the state usually decides to control prices in order to prevent social hardships and thus at least attempts to help some part of the population, usually the poorest. The corporation, in contrast, from a business point of view, would not be a very successful economic entity if it cared too much about anything other than maximizing profits.

A company will therefore always exploit the maximum latitude given by law and will tend to reduce competition as much as possible by, for instance, eliminating competitors and hindering new competitors from entering the market through the creation of entry barriers, because this strategy helps to produce cheaper and sell more expensive, and thus ultimately dramatically increases profits. All these activities, while being, at least in short and medium term, rational behavior from the point of view of the corporation, are not conducive to the welfare of society because the emergence of new market entrants which could potentially add to economic growth is suppressed and consumers are paying higher prices than necessary. The low domestic competition intensity caused by reduced *de novo* private sector expansion may also weaken incumbent companies' long-run competitiveness on the global markets and thus its long term economic performance potential which again hurts the national economy.

The danger of privatizing firms without having established sound competition regulations in advance is that the government gives up direct control over activities of a given state-owned enterprise (SOE) without any binding or enforceable reassurance that the newly privatized firm will abide to principles of fair competition. Giving up this control may yield good outcomes in countries where a sound regulatory framework is enforced effectively. However, in countries where competition law and enforcement are weak, chances are high that companies will not behave in a way consistent with principles of fair competition, but instead will tend to circumvent or ignore whatever regulations exist. It would seem inappropriate to assume that SOEs always behave in accordance to these principles. However, the government usually supervises, to some extent, the economic activities of SOEs and reserves the right to intervene and impose fairer competition. Once having privatized a firm, this mechanism of direct control is not to the disposal of the government any longer.

From the perspective of a privatized company as for any other private economic entity, disrespecting principles of fair competition may even be an existential necessity because other competitors would do or are doing the same, and renouncing any anticompetitive behavior would result into a competitive disadvantage. In countries where widely accepted and enforced competition regulations are missing, unfair competitive behavior in itself may thus become a competitive advantage. Under such circumstances the positive effect of privatization on competition intensity and efficiency may be diminished.

In transition countries, where the corporate size of the overwhelming part of newly created private firms is very small because they had to begin “from scratch”, privatized firms, especially some bigger former SOEs which have a dominant position within a given industry, bear a particularly high danger for fair competition. Once privatized without being limited by an effective competition law, former SOEs may use their market power to engage in all kinds of uncompetitive behavior in order to reduce competition within their region and respective industry. They may, for instance, create artificial market entry barriers for new entrants by unfair means such as dumping. Monopoly firms may ask exaggerated prices from their customers knowing that they are the only ones who offer certain services. In an oligopolistic market, firms may engage in price-fixing, coordinated restriction of output and market division among competitors in order to artificially keep prices high. Former SOEs may also capitalize on old bonds with the political leadership, skewing the competition to their advantage. The border line between elite behaviors that are merely worth criticizing at best and criminal and corruptive at worst is fluent.

The examples above illustrate mechanisms through which the privatizing of firms in the absence of sound competition regulations may hurt consumers as well as the newly emerging private sector. It would therefore appear that it is necessary to impose comprehensive restrictions on all economic actors, in particularly privatized firms, to ensure that privatization contributes to the intensification of (fair) competition and the well-functioning of markets, thus channeling the market forces into activities that are beneficial for both, the individual firm as well as the society as a whole. A good legal framework, including sound competition law regulations, is expected to be very helpful in order to harmonize the interests of privatized companies with the interests of society. As humankind has not developed a better way of societal organization, the responsibility of ensuring fair competition falls into the hands of the political leadership of a country. There is not one single highly developed industrial country in the world which has not created and does not enforce a legal framework that regulates and limits economic behavior in order to protect fair competition. This does not mean that in these countries unfair competition does not exist at all; this is a utopian ideal-type. It is, however, secure to say that in highly developed countries fair domestic competition is generally significantly more protected than in less developed countries. Markets need to be regulated so that the competitive battle over market share does not undermine the right of each market participant to fair competition. Just as personal freedom, to use an analogy, ends where another person's freedom begins, in business life, competitive behavior must be regulated where it limits the right of others to compete or otherwise participate in the market.

In summary, comprehensive competition law regulations and their consequent enforcement are expected to positively affect privatization success, particularly competition intensity and productivity improvement. For all the reasons stated above, the interplay of effective competition policy and privatization is expected to lead to better economic outcomes. Specifically, the main effect of higher competition intensity due to a fair market is an increase in average productivity of firms which accelerates economic development. In addition, fair competition eliminates market distortions caused by anticompetitive behavior and thus secures a healthy and efficient market which also supports economic development. Therefore, it seems reasonable to predict that rapid privatization without enough attention to the effective protection of fair competition will yield less satisfactory results than a privatization process that has been preceded by a process of building the institutional capacities necessary to secure fair competition. Thus, the logical chain is as follows: Privatization needs to be accompanied by effective competition regulations to guarantee a fair and competitive market. More Competition results in more productivity and economic growth. Consequently, it is expected that Poland's privatization process was more successful than Russia's because Poland either had more sophisticated competition regulations or because existing regulations were enforced more vigorously or a combination of both.

Evidence that would support this view is expert opinion that suggests that Russia's competition regulations were either underdeveloped or insufficiently enforced. The competition regulations looked at concern the portion of competition policy that focuses on incumbents. They include de-monopolization, control over mergers and acquisitions (M&As) that endanger fair competition, control over cartelization and penalizing for restrictive business practices, such as price fixing, predatory pricing to eliminate competitors or deter entrants (see also Table 2.1).

Shareholder rights against self-dealing

Company law mainly governs the creation, regulation, and liability of corporate entities. Among other things it addresses the, for this thesis relevant, questions of how a corporation operates and what the rights and duties of directors and shareholders are. The existence of clear and sound rules about what the management and owners of privatized firms are allowed and what they are not allowed to do, specifically in terms of internal affairs within the company, is expected to be highly important for privatization success. Without effective protection of shareholder rights, the assets of a privatized company may be looted legally by the new owner so that the opposite is achieved of what privatization is supposed to: Instead of adding more value to the company through privatization, value is being destroyed as assets are being stolen. The assumption of entrepreneurial freedom cannot hold to the extent that the new dominant owners should be able to proceed with their newly acquired assets in a way that is detrimental for the national economy. Besides moral considerations about the common good there is also the argument that the formerly SOEs are usually sold much below actual market value with the implied requirement that the privatized company will be managed more efficiently and that value will be added through further investments and subsequent profits which is mutually beneficent for both the privatized corporation as well as society as a whole. In addition, such behavior undermines the legitimate rights of minority shareholders and different stakeholders.

Self-dealing means theft from minority shareholders. It is expected to appear more likely if the shareholders have little legal means to enforce their rights as company owners. As long as a firm is not privatized yet, the state as the main shareholder has a stronger position against such counter-productive behavior. Once privatized without a regulatory framework protecting shareholder rights, however, abusive behavior is expected to appear more frequently and on a higher scale.

It seems reasonable to expect that the existence and enforcement of shareholder rights limiting self-dealing was an important determinant of privatization success in Poland and Russia. This expectation would be supported by evidence that in Russia there was indeed a higher level of looting of privatized companies and that there was an institutional underdevelopment in terms of enforcing shareholder rights regulating self-dealing in Russia compared to Poland (see Table 2.1).

Anti-Corruption institutions

Of the three institutional factors, institutions preventing excessive corruption might be the most crucial for privatization success. Whereas the above described behaviors can be partly characterized as private sector corruption, in this section corruption is defined as the abuse of public office for private gains (which do not necessarily need to be financial in nature). Corruption can take different forms such as bribery, patronage, influence peddling or theft.

The lack of a vigorously enforced effective legal system against corruption, may for example increase the likelihood that a firm which has an objective value of hundreds of millions of dollars is sold for only a fraction to individuals with connections to policy makers and financial means to bribe them. In such a case, the consequences for the budget situation are negative. The government is forced to compensate foregone privatization revenues by maintaining high taxes which hurts private investments and consumption as well as by cutting important expenditure such as investments in infrastructure, education and welfare. Corruption also increases the likelihood that buy-out candidates are chosen not based on crucial criteria such as managerial know-how and investment capital liquidity, but based on the amount of bribe money the candidate was willing to pay. This would have important consequences on the long-term success potential of the privatized company and thus on the whole economy.

Probably even more importantly, corruption in the executive (police, prosecutors) and the judicative (courts) may reduce the effectiveness of the overall legal framework through suboptimal enforcement of existing laws, including the laws mentioned earlier. Thus, the lack of effective institutions controlling corruption may not only directly affect privatization success but it may also have a negative indirect impact on privatization success through reducing the effectiveness of both the legal framework which is supposed to govern the privatization process and its enforcement.

Thus, it is expected that Poland's privatization process was more successful than Russia's because Poland's institutional framework succeeded better to control corruption. Evidence would have to include data about the anti-corruption institutions in both countries. Also, a widely accepted index such as the corruption perception index (CPI) may be useful to show the degree of corruption in both countries (see Table 2.1).

Table 2.1: Evidence that would support hypothesis

Independent variable: Rule of law		Dependent variable: Relative privatization success	
Selected examples of rules of the game	Expectations	Sub-variables	Expected effect on indicators
Fair competition	Polish competition law more comprehensive whereas neglect of certain areas in Russian competition law Polish competition law more concrete than Russian law leaving less room for discretion and arbitrary decisions Better funding of Polish supervisory and enforcing institutions More effective penalties in Poland	Competition intensity	*Small business density* expected to be higher in Poland than in Russia *Productivity improvements* expected to be effected positively

Shareholder rights	Polish regulations on shareholder rights better developed than Russian Poland expected to perform better on shareholder rights index Disrespect for shareholder rights is expected to be more obvious and far-reaching in Russia compared to Poland	Self-dealing	Share of start-up firms exploiting *physical capital originating from state enterprises* expected to be higher in Russia than in Poland *Net fixed capital formation* expected to be superior in Poland
Anti-corruption	Significant differences in level of corruption expected with Poland performing better Difference in determination of political leadership to combat corruption expected Differences in institutional infrastructure controlling corruption expected	Privatization revenues	Higher *privatization revenues* expected for Poland compared to Russia
		Enforcement of rules	e.g. indirect negative effect on small business density due to increased ineffectiveness of competition law with Russia suffering even more than Poland as corruption higher

Source: Own representation

Privatization method

Besides examining certain preconditions that may be necessary in order for privatization to yield successes it seems also important to look at the methods used to transform ownership from the state to the private sector. The methods used have important implications for the resulting ownership structure of the privatized firms. It seems reasonable to expect that the question of who owns privatized firms has consequences for the privatization success, or in more operational terms, on productivity improvement as well as on the other three indicators of the dependent variable. Differences in privatization success between Poland and Russia may therefore also be resulting from different privatization methods.

If restitution of formerly expropriated private property is excluded (see definition of privatization above), there are two basic (technical) privatization methods, the case-by-case privatization and the mass privatization method. The case-by-case privatization involves either direct sale of corporate assets, on the one side, or corporatizing an SOE first and selling the shares afterwards, also known as capital or indirect privatization, on the other side. It is strongly associated with a more concentrated ownership. Mass privatization in transition countries is most often done through issuing and distributing vouchers. These vouchers entitle the owner to acquire shares of companies participating in this kind of privatization program. The result of voucher privatization is generally a more diffuse ownership. The second dimension of privatization method and associated ownership structure, besides technical method and associated ownership concentration, is the question whether the new owners are insiders or outsiders. Thus, whereas some define 'privatization method' only in technical terms (e.g. sale versus voucher), I add to the definition also the type of owner to whom the company is being privatized. Sometimes, these two dimensions are confounded because they are partly related, but in fact, they should be treated distinctly.

Case-by-case privatization is strongly associated with concentrated ownership and is therefore expected to lead to better success than mass privatization for several reasons. First, concentrated ownership facilitates the formulation and communication of certain performance expectations and may thus be more effective in influencing managerial behavior toward the goal of efficiency gains. Second, the implementation and goal achievement may be monitored more effectively if ownership of a given company is less dispersed. Also, controlling of insider self-dealing may be more effective. Third, voucher privatization generally means a very small private involvement whereas direct sale usually means investing serious resources. An investor who has a lot to lose because he is heavily financially involved is more likely to identify with the company and act in its best interest than somebody who received an insignificant amount of shares almost for free. Fourth, case-by-case ownership transformation increases the probability of finding the most appropriate owner because the potential buyers need to compete against each other with the best restructuring plan. Fifth, case-by-case privatization generates higher revenues for the fiscal budget whereas vouchers are usually distributed at a symbolic price. The main arguments for mass privatization are that this method allows faster ownership transformation and that the whole society participates through voucher distribution. Fast ownership transformation, however, has, as noted earlier, historically proven not to be the most important criteria for economic success. The social effect of the voucher distribution is expected to be very small.

On the question whether insider or outsider ownership yields more privatization success the answer is miscellaneous *a priori*. Insider ownership may be associated with high levels of motivation because managers and workers are working 'for themselves'. This important advantage of insider ownership is, however, counterbalanced by inconveniences. First, selling a company to insiders may not be followed by sufficient new investment whereas outsiders, for example strategic investors, are more likely to bring new management and 'fresh' capital into the company thus improving corporate productivity. Second, in firms controlled by insiders a conflict of interests may emerge which, in turn, might hurt corporate performance. A possible consequence of insider ownership, for example, may be that restructuring measures necessary for turning a company around such as reducing the workforce or restraining wages are not executed because they interfere with other insider interests. Even worse, looting assets might be individually more rational than investing into the firm. Third, management and employees may buy a company not because they are the 'right owners' and because this is the best for the company, but in order to secure their work place and position. In each of these cases the effects of insider ownership for privatization success are expected to be suboptimal. On the whole, from a theoretical point of view, it can cautiously be expected that privatization to outsiders may lead to more privatization success than insider ownership.

If one thinks of the two dimensions from above as forming a matrix, then there are four possible combinations (see figure 2.1). Field (I) represents the indirect or direct sale to outsiders. An example would be strategic investors. Field (II) stands for insider buyouts by managers or workers through sale, most often employee-leasing. Field (III) represents mass privatization to outsiders which is usually done through free vouchers for every citizen. Field (IV) stands for insider buyouts through mass privatization programs.

Figure 2.1: Two main dimensions of privatization method

<table>
<tr><td colspan="2" rowspan="2">Privatization method</td><td colspan="2">Privatization method
- technical -
(Ownership concentration)</td></tr>
<tr><td>predominantly
Case-by-case privatization
(Concentrated ownership)</td><td>predominantly
Mass privatization
(Diffuse ownership)</td></tr>
<tr><td rowspan="2">Privatization method
- target group -
(Basic owner type)</td><td>predominantly
to outsiders</td><td>I</td><td>III</td></tr>
<tr><td>predominantly
to insiders</td><td>II</td><td>IV</td></tr>
</table>

Source: Own representation[6]

Combining the argumentation from above it seems reasonable to expect that case-by-case privatization to outsiders (field (I)) leads to highest privatization success. Consequently field

[6] Any resemblance to other representations of these concepts is accidental and beyond the author's knowledge.

(IV) would be expected to perform least well. Because the argumentation above is more categorical on the dimension ‘ownership concentration’ than on the dimension ‘owner type’ it follows that the combination field (II) is expected to be relatively more successful than field (III). Consequently, the assumed ranking of method of ownership transformation is I, II, III, IV from most to least favorable for privatization success.

Thus, a second hypothesis is that Poland’s privatization process was more successful because of the chosen privatization method. Specifically, it is hypothesized that the privatization process in Poland yielded better micro- and macroeconomic results than in Russia because Poland chose a privatization method associated with an ownership structure that is comparatively more conducive to privatization success.

CHAPTER 3

RULE OF LAW IN POLAND AND RUSSIA

The main hypothesis emphasizes the importance of the rule of law for privatization success. The concept of the rule of law is represented by the following three examples: Rules securing fair competition, rules protecting shareholders from self-dealing and rules against corruption.

Fair competition

The first of three examples supposed to represent the concept of the rule of law is the enforcement of rules protecting fair competition. Because of theoretical reasons, it is expected that before and during the privatization process (in the regarded period 1991-1995) Poland paid more attention than Russia to the establishment of an institutional framework which later, once most companies were privatized, would represent the basis for securing fair competition, thus contributing to the success of privatization. The underlying assumptions are that, first, Polish (compared to Russian) privatized companies engaged less in unfair market behavior. Second, the new Polish private sector which faced less entry barriers from incumbent firms developed faster, which, in turn, contributed to more corporate productivity improvement and macroeconomic success. Third, the institutional framework protecting fair competition was indeed more developed in Poland than in Russia.

Unfair market behavior

Business entry was significantly more difficult for Russian than for Polish new businesses. Unfair market behavior in Russia was more pronounced than in Poland. Referring mainly to the period after 1995 (period of dependent variable), Broadman (2000) notes that "horizontal and vertical dominance among incumbent firms and barriers to entry by new businesses are considerably more pronounced in Russia's industrial sector relative to many other transition economies (…) It appears that there remains considerable potential for abuse of market power in Russia" (p. 1). As consequences of this market domination by incumbent firms and high entry barriers, he mentions "(i) high prices, reduced output and diminished product and service quality (…); (ii) diminished incentives for inter-regional trade among regions, thus retarding formation of a unified economic space; (iii) reduced business investment from foreign sources; and (iv) stifled innovation and technological advancement" (p. 1). All of these factors inhibit the optimal allocation of resources and thus reduces productivity and long term economic growth. The two main causes identified are protectionist regulations and the lack of a rules-based institutional framework for implementing competition policy. The second point shall be examined more closely later in this section. Broadman's assessment is also confirmed by the Index of Economic Freedom[7] which summarizes obstacles for new businesses. While in 1995 Poland was ranked 54th, Russia was ranked only 100th out of 123 countries (see Gwartney et al. 2001).

[7] published by the Fraser Institute

De novo private sector development

Not surprisingly, the *de novo* private sector in Poland became much more important than in Russia. The lower level of entry barriers not only contributed to higher domestic investments but also attracted foreign investors who rather than buying existing companies often decided to create new ones. This fact is reflected by the relatively high estimated share of more than 50 per cent greenfield investments (as opposed to investments in existing privatized firms) as a share of total foreign investments which is higher than in most other transition countries, including Russia (see Schöllmann 2001, Jermakowicz 1994). According to Winiecki (2000) the entrepreneurial density (number of entrepreneurs per 1000) was 59 in Poland in 1998 and only 6 in Russia in 1996. Even though it should be considered that this data is for two different years and that the grey economy is not included, the ratio of 10:1 of these numbers is very high and supports the assumption that lower market entry barriers in Poland in terms of fairer behavior of incumbent firms, helped the newly emerging private sector to develop faster. Similar numbers are also available for 1995: Poland had about two million small private businesses whereas Russia had only half as much (one million) with a population which is four times larger (see Frye et al. 1997, Winiecki 2000). Based on these numbers I calculate a density of small private business of roughly 53 in Poland and only 7 in Russia (per 1000 citizens). The ratio of almost 8:1 is again very high. What these numbers clearly show is that over the whole period of the dependent variable the small private sector in Poland played a significantly more important economic role than in Russia.

The beneficial effects of the high number of new market entrants for the national economy were very important. In the literature it is argued convincingly that the newly emerging private firms were crucial for the development of the private sector and economic growth in

Poland (see for example Blaszczyk 1999, Broadman et al 2000). In addition, the newly created companies played a crucial social role as they represented an important absorption capacity for workers that have been dismissed due to restructuring of the privatized firms (see e.g. Jackson et al. 2002, Table 3.1).

Table 3.1: Unemployment rate

In %	1996	1997	1998
Poland	13.2	10.3	10.4
Russian Federation	10	11.2	12.4

Source: UNECE

Table 3.1 shows that while the Polish unemployment rate fell from 13.2 to 10.4 per cent over the regarded period, the unemployment rate in Russia increased from 10 to 12.4 per cent. The higher level of unemployment in 1996 in Poland may be explainable by more intensive restructuring efforts. Svejnar (2001) notes for the early transition period that unemployment in the CIS countries rose more gradually because firms were more reluctant to lay off workers thus jeopardizing the goal of becoming more productive. The important point here is that for the examined period the unemployment rate showed a positive trend in Poland and a negative trend in Russia. Thus, it can be assumed with some level of confidence that Poland had at this point overcome the largest costs of transition in the labor market whereas for Russia it appears that these costs were not fully exhausted.

The said above is not to underestimate the importance of privatized companies for national economic performance, but rather to underline how crucial it is that public monopolies are not just transformed into very difficultly controllable private monopolies which try to maintain control over the market but that they become economic entities that participate fairly in a competitive market leaving room for new challengers. Also, the higher number of market participants is strongly associated with more competition intensity. The crucial importance of competition intensity for productivity improvements is impressively documented by Djankov et Murrell (2000) who analyze and synthesize 125 empirical studies on enterprise restructuring in transition. One implication from the data of the surveyed studies is that in non-CIS countries firms that face near perfect competition are 30 per cent more efficient than enterprises that operate in near monopoly markets; for CIS countries this number amounts to even 40-60 per cent. In summary, competition was less fair in Russia than in Poland and this fact seems to have contributed to significant differences in *de novo* private sector expansion and productivity improvements. Thus, the first two assumptions stated earlier are supported by real world developments in Poland and Russia. The third assumption is examined next.

Competition law and enforcement

It is argued earlier that sound competition policies are crucial for achieving a central goal of privatization – intensifying (fair) competition and thus increasing productivity and efficiency. Competition law[8] enforcement is supposed to protect investors both foreign and domestic from anticompetitive behavior by incumbent dominant enterprises and to ensure that they are treated fairly in their business operations by the authorities. They must also give confidence to the public that abusive and monopolistic behavior will not be the outcome of the transition to a market economy (see Pittman 1998). Table 3.2 shows how the EBRD assessed the competition policy in Poland and Russia.

[8] In the United States' statutory language the word "Antitrust" law is used.

Table 3.2: EBRD Index of competition policy

	1991	1992	1993	1994
Poland	2	2	3	3
Russian Federation	2	2	2	2

Source: EBRD Transition Report 2002

Only for the years 1993 and 1994 are differences in competition policy found. These two years coincide precisely with main privatization efforts in Russia and the difference in these two years is in accordance with expectations. The small range of the scale (1-4), however, is unfortunate and it is rather arbitrary to decide whether the difference is substantial. Therefore, it appears helpful to examine competition law and enforcement more in depth. The following section analyzes differences in the statutory language and the enforcement of competition regulations.

Joskow et al (1994) is a very important reference in the domain of Russian competition policy and the for this thesis relevant points shall be summarized briefly: Russian competition law became effective on May 1, 1991 and the law providing the legal foundation for the later privatization program was adopted in July of that year, both before the formal dissolution of the Soviet Union in December 1991 under the newly elected President Boris Yeltsin (p. 331). The 1991 Russian antimonopoly law focused largely on the abuse of dominant market positions, but neglected the areas of cartelization and exclusionary practices. It is also noted that Russian policies were not sufficiently directed toward the creation of appropriate industry structures and effective regulatory institutions to govern natural monopolies (p. 364) while at the same time the Russian reformers, despite the high degree of industrial concentration, did not follow the standard prescription to de-monopolize before privatizing (p. 305). The definition of "abusive actions" in Article 5 is assessed by Joskow et al. to be too general leaving too much space for interpretation and discretion, thus endangering "innocent" competition (p. 337).

Examining the enforcement of the Russian competition law, Black et al. (2003) note that the by Article 3 created antimonopoly committees were staffed with weak leaders who then hired weak staff. This is in accordance with the assessment in Joskow et al. who note that the committees did not have the relevant expertise because during socialist times non-Marxist economics and (Western style) commercial law were not taught. In addition, the committees lacked resources, including office space, telephone service, insufficient number of staff members and other (p. 335, 336). A very important point Joskow et al. raise is that even though the new Russian antitrust law foresaw criminal penalties for antimonopoly violations of up to two years, these sanctions seem to have never been invoked.[9] The maximum fines in the statute had almost no deterrent effect because they had been rendered "relatively unimportant by inflation" (p. 338). Pittman (1998) notes that even though Article 29 allows for de-monopolization, failure of the Antimonopoly Committee to issue appropriate regulations has limited the usefulness of the provision of this law. On the question of whether good competition policies can work in Russia (or from today's perspective speaking we must say 'could have worked') Joskow et al. (1994) are affirmative. They find that a "economy of monopolists" does not have to be Russia's destiny, but that in the medium term, sound policies could create a "relatively competitive Russian economy" (pp. 305, 306). On the whole it appears that Russian competition law was partly flawed and imperfect, but nevertheless provided some appropriate legal constraints for

[9] This statement refers, of course, only to the transition period prior to the referenced article, thus prior to 1994.

anticompetitive business behavior. However, even though Russian competition law was not too bad on paper, there were serious implementation and enforcement problems.

Poland is generally regarded as a transition country that was very market-oriented in comparison with other transition countries. The government tried to foster competition by diluting any monopoly power state firms might have had (see e.g. Pinto et al. 1994).

Poland was one of the very first transition countries to enact competition laws. The Polish Antimonopoly Act became effective in 1990 and is assessed by Gray et al. (1991) to provide a comprehensive framework for competition law and practice to develop. Broad principles defining illegal behavior are established. Whereas the Russian competition law left much discretion to the Antimonopoly Committee on the assessment whether a horizontal agreement is anticompetitive or not (Article 6.3), the statutory language in the Polish law was stronger and more concrete. The Polish competition law was, similar to Russian law, particularly adamant on preventing abuse of a dominant position. However, whereas in the Russian competition law from 1991 the definition of abusive action was very general and little attention was given to cartelization, the Polish law was very explicit and all-encompassing. Article 4 and 5 both explicitly restricted vertical integration by mentioning concrete examples of anticompetitive behavior of incumbent firms (see Pittman 1998). Article 4.1 defined four types of monopolistic practices. Article 4.2 enlarged the definition of monopolistic practices by explicitly mentioning price-fixing among competitors, geographical or product-specific market division, restriction of output, sales, or procurement, limiting market access to third parties and fixing the terms of contracts with third parties. Article 5 not only defined when a dominant market position is considered monopolistic but also listed concrete examples of such abuse (Gray et al. 1991).

Article 12 even threatened dominant firms that they may be dissolved if they permanently restrain competition (see Pittman 1998).

The Law also established a specialized office for prosecution, the Antimonopoly Office, with broad powers to investigate and, if justified, to order the abandonment of anti-competitive practices. It had the right to impose monetary fines of up to 15 per cent of annual income as opposed to fixed fines in Russia which lost any effect due to very high inflation. In special cases, violating firms could be ordered to be broken up or dissolved. Thus, the institutional infrastructure in Poland provided a much better basis for the effective application and enforcement of competition regulations than in Russia.

However, it shall be noted that during the research for this thesis some other very important factors inhibiting the emergence of a new private sector have been identified. These factors are related to a more comprehensive overall competition policy which regulates where necessary but also deregulates where possible. In addition to the insufficient protection from anticompetitive behavior, the new private entrants were facing important entry barriers resulting from overregulation in areas such as complicated licensing and registration procedures, excessive and biased inspection activities, and complexity of the tax burden as well as missing fundamentals such as difficult procurement of capital, unpredictability due to changing rules and organized crime. All these other entry barriers seem also to have an important impact on privatization success but as they do not directly relate to the behavior of incumbent firms they shall not be treated here. It shall only be noted that for privatization to effectively increase competition intensity and productivity, institutions protecting competition seem to be necessary but not sufficient. Thus, the expectation that the effective enforcement of competition regulations contributed to more privatization success in Poland compared to Russia seems to be supported by empirical evidence, but there are other important factors too.

Shareholders rights protecting against self-dealing

> *We have learned that Western-style capitalism is more fragile than we thought. It will not emerge – certainly not quickly, perhaps not at all – if seeds are simply scattered widely through mass privatization, to grow in the thin soil of an institutionally impoverished country. Instead, the institutions that control theft in its myriad forms, especially self-dealing by managers and controlling shareholders, are an essential fertilizer.*
>
> Black et al. 2000, p. 1797

The second example representing the concept of the rule of law is the regulatory framework which is supposed to protect shareholders from abusive behavior of insiders and dominating shareholders. It is expected that Poland installed a more effective legal system supposed to protect shareholders from self-dealing than Russia which resulted into less looting of otherwise viable privatized companies. Obviously, more such destructive behavior for private gains must have negative effects on the performance of privatized companies as well as on the whole domestic economy. The productive capacities of a looted company are reduced which can eventually endanger its viability with all consequences for society. Because of lack of capital it also cannot be expected that looted assets are replaced easily by new ones. In addition, assets that have been exported cannot add to national output and wealth creation within the country. A necessary condition for the expectation above to be true is that self-dealing was indeed less common in Poland than in Russia.

Self-dealing in Poland and Russia

Kolodko and Nuti (1997) note that the relatively better approach toward privatization is also reflected in the fact that Poland made most progress in the domain of corporate governance (see Table 3.3).

Table 3.3: A Corporate Governance Scorecard (1996)

Corporate Governance	Poland	For comparison: Hungary	For comparison: Czech Republic	Russian Federation
Disclosure How strong are requirements making investors reveal large shareholdings?	****	**	*	*
Transparency How well do listed share prices reflect actual market activities?	****	***	**	*
Corporate results How good are reporting requirements for corporate earnings?	****	***	***	*
Protection How well are small shareholders protected from abuses by majority owners?	***	**	**	*
Insider trading How free is the market from insider dealing?	***	**	**	*
Key: Excellent **** Good *** Passable ** Shoddy *				

Source: Kolodko & Nuti 1997

Table 3.3 shows that in all different areas of corporate governance the situation in Poland is assessed to be significantly better than in Russia. Of special interest here is one sub-domain of corporate governance – shareholder protection. While the protection of shareholders from abuses of dominant shareholders in Poland is generally described as ‘good’, in Russia the average assessment is very negative or ‘shoddy’. This assessment is also supported if we try to estimate and to compare real self-dealing in Poland and Russia.

There is almost no empirical research on looting in transition countries. One first attempt of measuring this by nature hidden and therefore very difficult to examine phenomenon, however, has been accomplished in Campos et al. (2002). Analyzing 1997 survey data from 950 start-up firms in five transition countries, Campos et al. find that looting is (much) more common in Russian than in Polish firms. The two proxies they use for looting are share of physical capital and of financing originating from state firms. Out of the 236 Polish start-up firms who answered the question only ten (4.2 per cent) responded that some or all assets originated from state firms whereas from the 81 Russian firms in the sample the corresponding number is 29 (35.8 per cent). On the question about capital finance from state enterprises the tendency is similar, but the absolute number of the positive answers by Polish and Russian firms is too small to be statistically significant and therefore I do not consider these results. Besides potential methodological problems[10] which are common in empirical work, this study is only of partial use for this thesis because the phrasing of the survey questions does not permit a distinction between looting in state versus looting in privatized firms. However, the empirical study of Campos et al. supports the view that there were significant differences in looting between Poland and Russia and it implies that one of the reasons were lack of institutions.

Boycko et al. (1993) indirectly estimate looting in Russia by looking at company valuation. They note that while U.S. manufacturing firms typically have a market valuation of $100,000 per employee, Russian privatized manufacturing firms were valued at only $100 per employee. They suggest that this 1000-fold difference is too high to be explained only by differences in living standards (roughly about 1:10), firms' profitability or lack of capital. They ask what other factors might have caused such an extremely low valuation of privatized firms.

[10] For example: the proxy might not necessarily be measuring exactly what it is supposed to, reliance on honesty of responding executives, stripped assets may have been exported, selection bias in company choice, etc.

Their explanation is a so-called "expropriation of shareholders by stakeholders" (p. 161). The benefiting stakeholders were workers, managers and the government[11]. Managers, not being constrained by effective institutions such as shareholder rights, expropriated shareholders by transferring assets to other economic entities within or, worse for the national economy, outside Russian soil. Boycko et al. note that this may be the principal reason for the enormous capital flight from Russia which only for 1992, thus at the beginning of the mass privatization program, is estimated to amount to $15 billion. In Hoff et al. (2002) this estimate is confirmed for later periods: Between 1995 and 2001 on average $15 billion to $20 billion roughly equal to 5% of GDP were 'exported' out of Russia each year. Whereas Poland was characterized by a positive private net fixed capital formation, in Russia the capital flight together with the low level of foreign and domestic investments led for the period 1996 to 1998 to a negative private net fixed capital formation which is detrimental for a national economy.

The evidence above clearly suggests that self-dealing in form of asset-looting was significantly more common on Russia than in Poland. In the following I shall compare the Russian and Polish institutional infrastructure protecting shareholders.

Shareholder rights

According to Black et al. (2000) Russia entirely lacked the institutional framework necessary to control self-dealing by executives of private firms. Important legal concepts to prevent self-dealing simply did not exist. For example, the Law on joint stock companies regulating important corporate governance issues was adopted only in December 1995 (Hashi et

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[11]According to Boycko et al. the workers profited mainly through wages and social benefits as Russian firms continued to pay for kindergartens, hospitals, schools and other services and the government contributed to the 'expropriation' through taxation, restrictions and political instability.

al. 2004). Hoff et al. (2002) confirms this assessment by noting that in Russia there were very few rules concerning corporate governance. Some laws to protect the rights of shareholders were adopted only in 1995-96, but even then political opposition contributed to weak enforcement.

Poland's corporate governance relations are regulated today mainly by the Polish Company Code which was enacted only in 2001 replacing the old Commercial Code from 1934. One particularity of the Polish legal system is that corporate governance for the formerly state-owned firms is in large parts governed by the two Privatization Acts passed, the first of which was adopted in 1990. Another important law protecting shareholder rights is the 1994 Act on Accounting which governs information and disclosure requirements of managers and large shareholders. Among other things it rules that financial statements must contain remuneration information of members of executive and supervisory boards which is an important control instrument for shareholders.

Pistor et al. (2000) offer a number of indices measuring different aspects of shareholder rights in transition countries. Table 3.4 shows three selected indices[12] for two points of time within the period of the independent variable: LLSVsh aims mainly at measuring the protection of minority shareholders. SMINTEGR codes rules ensuring the integrity of the capital market and includes amongst other self-dealing. ANTIMANAGE describes rules which concern the ability of shareholders to challenge management decisions and actions.

[12] These are shareholder rights indices which are more closely related to self-dealing.

Table 3.4: Shareholder rights indices

	LLSVsh		SMINTEGR		ANTIMANAGE	
	1992	1994	1992	1994	1992	1994
Poland	3	3	4	4	3	3
Russian Federation	2	2.5	2	3	3	3
Range: 0-6						

Source: Pistor et al. (2000)

The numbers for the first two variables are in accordance with expectations. However, laws protecting shareholder rights are not evaluated particularly well in 1992 and 1994 in both countries. In addition, for the third variable ANTIMANAGE, which is exactly the variable that (of the three variables) refers most to enforcement of non-abusive manager behavior by shareholders themselves, there is no difference between Poland and Russia. Thus, this index data which measures shareholder rights 'on paper' is only partly in accordance with expectations. On the whole, the index data suggests that the framework of laws protecting shareholders was (only) somewhat more developed in Poland compared to Russia which, even though weakly, supports expectations. On an aggregate level (looking at all transition countries in their sample), however, Pistor et al. (2000) find that it is not only the law that matters but also its enforcement: "Good laws cannot substitute for enforcement" (p. 25).

The above mentioned 1995 Russian Law on joint stock companies ameliorated the poor law enforcement to some extent in terms of more appropriate use of procedural methods which were almost completely ignored earlier (first half of 1990s): For example, shareholders were not informed about shareholder meetings, board members elections and other votes were not carried out in accordance with the corporate law, outside investors were ignored for manager positions, there was a strong opposition to independent audits, small shareholders were disadvantaged upon the distribution of dividends, minority shares were diluted through formal capital increase and so on. While these problems continued to be also important in the second half of the 1990s in Russia and are still present even today, the enforcement situation was particularly unfavorable at the time of main privatization efforts. Between 1993 and 1995 there are even reported cases of armed takeover of companies (see e.g. Hashi et al. 2004, Black et al. 2000). All these problems are connected to what Boycko et al. call ‘expropriation of shareholders’ as they significantly decrease the ability of shareholders to control self-dealing. In Russia, laws were incomplete and the combination of legal loopholes and an inappropriate enforcement system facilitated abusive behavior. Managers faced less restraints to either simply sell assets (of the privatized company they worked for) for private gains to anybody willing to pay or to transfer (“pump out”) assets and financial means to own companies and bank accounts within or outside Russia. According to Hashi et al. such for the company and national economy detrimental behavior can primarily be explained by the unstable situation in the corporate control which is governed by institutions. Gogek (1995) emphasizes especially the importance of law enforcement. The main problem of Russian company law was not so much the legal texts themselves, but their application. The law included sanctions for which the enforcement was uncertain. Rules were in force which had simply nothing in common with day-to-day practice. Federal laws were interpreted and enforced from region to region differently.

Enforcement of shareholder rights was also insufficient in Poland. Hashi et al. note that, in practice, there were numerous cases in Poland, too, where shareholders and managers have behaved abusively. According to Hashi et al. one important reason for poor enforcement is that the laws were often too general and not instructive enough. Legal loopholes existed that allowed managers to strip profits and assets legally and thus rendered other laws protecting shareholders ineffective. In addition, courts and prosecutors had insufficient skills to counteract illegal abusive business behavior.

As a whole, it appears that law and enforcement of shareholder protection was only somewhat better in Poland compared to Russia. However, the data on Poland is miscellaneous and the differences between the two countries in terms of the observed institutional infrastructure protecting the rights of shareholders are smaller than expected. The estimated positive relationship between effective institutions protecting shareholder rights and degree of self-dealing cannot be rejected, but it does not appear to be very strong either. The explanatory power of shareholder rights appears weaker than initially expected. There are other institutions, such as effective enforcement of property rights and criminal law that may have a more important influence on self-dealing.

Institutions controlling corruption

Earlier I articulated the expectation that Poland's privatization process was more successful because its institutional framework was more effective in controlling corruption. Corruption is expected to negatively influence the success of the privatization process in many different ways. Here I can focus only on some mechanisms: First, one direct impact of corruption is expected to be manifested in differences in privatization revenues. Second, indirect effects are expected to be found in that existing rules are not enforced appropriately due to corruption.

Thus, the institutional framework controlling corruption, the third example of institutions examined in this thesis, differs from the other two examples above because anti-corruption institutions are expected to be important not only by themselves but also through their impact on the effective enforcement of the whole legal system, thus also on effective enforcement of fair competition and shareholder rights (see Figure 3.1).

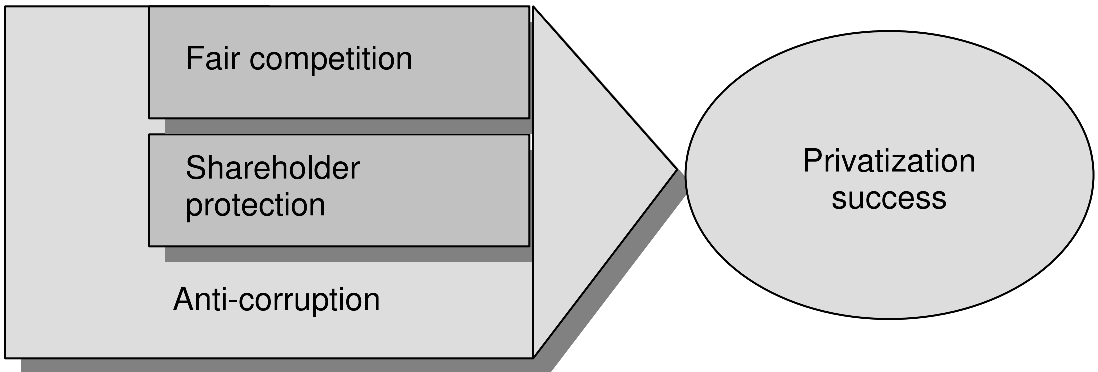

Figure 3.1: Examples of important rules of the game[13]

The assumptions are: First, corruption in Poland tended to be higher in Poland compared to Russia. Second, there were significant differences in privatization revenues that cannot simply be explained by objective company valuation through the market. Third, corruption weakens the enforcement of laws. Fourth, anti-corruption laws and policies were more developed in Poland than in Russia.

Corruption in Poland and Russia

More or less pronounced corruption and bribery existed and still exists in all transition countries but the level it reached in Russia (and some other CIS) countries is astounding. Corruption is very intensive in practically all levels of public life – legislators, bureaucrats, police, prosecutors, and the judicative (see e.g. Black et al. 2003). The Corruption Perception index allows a quantitative comparison of level of corruption between Poland and Russia with lower numbers (range 0-10) representing a higher degree of perceived corruption (see Table 3.5).

Table 3.5: Corruption Perception Index (CPI)

CPI	1988-1992	1996	1997	1998
Poland	5.2	5.6	5.1	4.6
Russian Federation	3.3	2.6	2.3	2.4

Source: Transparency International & University of Göttingen & University of Passau

Unfortunately, there exists no CPI data for the time period 1993-1995 for Poland and Russia[14] but from all the qualitative data available there is no indication that the perception of corruption in the years 1993-1995 was dramatically different from the years before and after that period. Thus, it can reasonably be assumed that for the period 1991-1994 there was a significant difference in the perception of corruption between the two examined countries. While in Poland the degree of corruption was perceived to be moderately high but still better than in most other transition countries, in Russia it was perceived to be very high reaching levels of developing countries such as Uganda, Indonesia or Cameroon.

Direct impact of corruption in terms of lost privatization revenues

Corruption is a crucial problem and affects privatization success in many different ways. One of the important direct impacts of excessive corruption on the privatization process is the negative fiscal effect in terms of lost revenues. In Russia, the whole privatization process was almost entirely corrupted and the abuse on a much higher scale than in Poland. For example, one common Mafia technique was to gain insider information from corrupted officials about state

[13] Source: Own representation

[14] The CPI index was initiated in 1995 and in 1996 Poland and Russia were included for the first time. The numbers for 1988-1992 have been generated ex postum by Transparency International and the University of Passau by using the following sources: (1) Business International, (2) Political Risk Service, East Syracuse, NY, (3) World Competitiveness Report, Institute for Management Development, Lausanne, (4) Political & Economic Risk Consultancy, Hong Kong

property scheduled to be privatized soon and then to push potential competitors aside (see UNPAN 1998 Country report on Russia). Russia's privatization program is an extreme example of where the wholesale of a large part of formerly SOEs can lead if the process is not protected effectively from anti-corruption institutions. From the main start of privatization in 1992 until 1995 a large quantity of SOEs was sold significantly below market value. The first (mass) privatization program transferred much of the state assets to the former elite, the 'nomenklatura'.

The second privatization program, so called 'shares for loans', targeted the privatization of Russia's most profitable industrial enterprises and the companies exploiting natural resources. These national 'crown jewels' were sold for only a fraction (often no more than one per cent) of its objective market value in exchange for political and financial support, e.g. in the reelection campaign of President Yeltsin (Black et al. 2000, Hoff et al. 2002). The list (e.g. Yukos, Sibneft, Gazprom, etc.) is long.

This, some call it, "anecdotal evidence" was not the exception in Russia, it was much rather the rule. It is very hard to find many cases where the privatization of a certain company was regular, where the doubt of corruption is unjustified, and where the price paid comes in any way close to the real firm value. Rather the privatization process in Russia was so corrupted, the generated revenues for the budget so low that it is appropriate to say that the Russian privatization process opened the way and significantly facilitated the theft of a huge amount of economic assets and resources of the Russian people.

> *Russia experienced a level of corruption really rare in the world. (…) Russia (…) had a lot to steal. And this is the rare combination, because there are a lot of corrupt places that don't have that much to steal, but Russia had this extraordinary combination of huge natural resource reserves, and they were in state hands. So you had all of these elements. You had the oil, the gas, the nickel, the chromium, the diamonds, the gold. They were in state hands for the taking, as it were.*
>
> PBS interview with Jeffrey D. Sachs, p. 25-26

It would be subject to a detailed study to assess by how much more Russia's budget has been ripped off due to higher corruption in the privatization process compared to Poland. But the following numbers shall at least give a little idea of the dimension of abuse. As explained above (see Introduction section) by 1995 Russia had reached and even surpassed the levels of privatization in Poland[15]. Russia's population (148.1 million) was almost four times larger than that of Poland (38.6 million) and the domestic product ($ 338 billion) was, due to the lower GDP per capita, not four but still almost three (exactly 2.7) times higher than that of Poland's ($ 126.4 billion) (Global Development Finance & World Development Indicators 2001). Depending on the source, the cumulated privatization revenues by 1995 in Poland amounted to $2.6 - $3 billion (see Bouton & Sumlinski 1996, Gorzynski et al. 2000). Based on these simple numbers it would seem reasonable to estimate that, view the advanced stage of ownership transformation, Russia's accumulated privatization revenues were also at least three times higher, thus $8 - $9 billion.

Such an estimate is probably too low because it does not consider at least two other important facts: First, and probably most importantly, Russia is a country rich of natural resources and one of the world's major supplier of oil, gas, aluminum and other resources. Some of the biggest companies (e.g. Yukos, LUKoil, Sidanko) had already been partly privatized by 1995, especially during the "loans-for-share" program which started after 1994 (World Bank - Development Economics Prospects Group). Second, Poland not only does not have any comparable large quantities of natural resources but also privatized its most valuable firms which generated the highest privatization revenues after 1995.

[15] in terms of share of number of privatized companies to total number of companies planned for privatization

Having these facts in mind, what were now the accumulated privatization revenues in Russia? According to data in Bouton & Sumlinski (1996) the figure amounts to a little more than $1.2 billion. Again, this figure already includes the partial privatization of oil-producing companies with some of the highest proven reserves in the world. Also, this very rough estimate refers only to lost direct privatization revenues due to corruption. Subsequent real or opportunity costs due to the aftermath of a corrupted privatization process are not included at all. They must be included as well because the corrupted Russian privatization process not only facilitated this one-time theft but also the subsequent continuing theft, mainly through asset-looting and tax evasion, some of which has been discussed above. Also not included is the loss of foregone efficiency gains due to the fact that the new owners were not chosen based on managerial know-how and access to capital.

I have not found any study that tries to concretely estimate the financial losses due to corruption in the privatization process with sound scientific methods. Probably such a study will never be done due to the in-transparent and secret nature of corruption and any estimate will remain highly speculative. However, the above numbers seem to justify the assessment that the Russian people have been betrayed on a much higher scale than the Polish people by even for Western standards important amounts of financial means. These billions of dollars which were lost due to excessive corruption could have been used productively in the domestic economy. They could have been invested in education, infrastructure and technology benefiting Russia's long-term competitiveness and they could have softened the enormous social problems due to transformation. A little (too) hypothetical but nevertheless interesting is the argument in Black et al. (2000) that only the (honest) privatization of Russia's biggest company Gazprom (who's objective market value is conservatively estimated to amount to $600 billion) "could have delivered $4,000 in value to each citizen" (p. 1775). The yearly income of most Russians is less than this amount.

Indirect impact of corruption due to weakening of law enforcement

Probably even more important is the indirect negative effect of corruption through undermining and weakening the effectiveness and enforcement of the existing legal framework. To stay in the framework of this thesis, corruption does not only directly decrease privatization success but also impacts the effectiveness of competition and investors' law (as well as of course other important 'rules of the game' which have not been included in this thesis but may also contribute to privatization success).

For example, the Russian Antimonopoly committee established very early a list of thousands of medium-sized firms, the so called 'Antimonopoly Register'. The criteria for being included in the list were not transparent and many firms were listed that were not in a dominant market position. To be excluded from the list companies had to bribe (see e.g. Black et al. 2003). Instead of competition regulations doing what they were supposed to, securing fair competition, they were used for private gains by bureaucrats and politicians who faced little probability of prosecution. Thus, excessive corruption in Russia undermined the effective enforcement of competition rules.

More generally, the enforcement of rules was undermined through excessive corruption in the judicial and executive branch. The judicial branch is probably the most important institution for securing effective enforcement of rules as it is the last instance in the chain of law application: Even if, hypothetically, the legislative and the executive branch were to work perfectly[16], then a corrupted judicial system can still render the whole legal system ineffective as it reserves the right of the last arbiter.

An important problem for the effective law enforcement in Russia was the under-funding of Russian courts. Monthly salaries of judges averaged around $200. This is only a fraction of what good private lawyers can earn, so that they do not apply to become judges. If judge salaries were raised this was done at the expense of budget for staff and court administration. (Black et al. 2003, Solomon 1999). Low remuneration, however, not only decreases the level of expertise among the judges but, under conditions of weak controlling institutions, also increases the likelihood of judges to accept bribes. For example, Solomon (1999) describes how dangerous offenders detained before trial, generally Mafiosi who had the means to pay for 'preferential treatment', were released by judges. For Black et al. (2003) "President Yeltsin's indifference to corruption was the single biggest missed opportunity early in the Russian transition" (p.58).

Corruption also played a more important role in Russia in terms of the earlier mentioned administrative barriers. On the one hand Russia tried on paper to reduce entry barriers through its competition law on the other hand the law was not only poorly enforced but the state also jeopardized its efforts by creating other entry barriers such as administrative regulations, thus indirectly strengthening the position of incumbent firms. Some such important and widespread mechanisms shall be mentioned as an example:

The registration and licensing procedure in Russia is compared to Poland complicated and non-transparent leaving a lot of leeway for arbitrary decision, blackmail and bribes. Radaev (2001) describes how branch offices of federal ministries responsible for issuing licenses and certifications have become (and still are) one of the main problems for new small firms. These

[16] This is of course only hypothetical and not true for any country in the world.

offices are given a high degree of autonomy by the federal authorities because of lack of resources and they compensate the low funding by producing administrative barriers and living off the rent.

Another example is the high number of inspections. The administrative regulations imposed too many inspections and left too much discretion to the person conducting them. As a result of the combination of this discretion, little probability of persecution and low salaries, inspecting officials in Russia too often engaged in corruptive behavior either by accepting bribes when the company did not meet the defined conditions or by using the full extent of discretion and actively blackmailing an honestly operating firm. Referring to the second half of the 1990s, Radaev (2001) notes that 65 per cent of the small entrepreneurs face extortion by the bureaucracy and 21 per cent confront it frequently. Based on a survey conducted with 250 Polish and Russian shopkeepers, Frye (1998) finds that whereas on average a shopkeeper in Warsaw was inspected by 2.6 agencies whose officials came to the shop nine times, a shopkeeper in Moscow had to face almost four agencies whose officials came 19 times. At the same time the Russian shopkeepers assessed corruption to be a much more important problem for their business (7.4)[17] than their Polish colleagues (3.1).

Table 3.6 shows the share of firms saying they are paying for bribes and protection. The differences between Poland and Russia are statistically and substantially significant. While in Poland only roughly two out of ten firms say that they pay bribes for licenses and other government services, in Russia the according number is nine out of ten firms.

[17] Scale from 1 (small problem) to 10 (major problem)

Table 3.6: Bribes and Protection Payments in Poland and Russia

Percentage of firms saying they make…	Poland	Russia	*t*-statistic for difference in means (base case Poland)
…extralegal payments for government services	20%	91%	17.3
…unofficial payments for licenses	19.3%	91.7%	18.3
…payments for "protection"	8%	92.9%	29.9

Source: Johnson et al (2000)

Lack of effective anti-corruption institutions leads to a paradoxical situation in Russia: Unnecessary regulations are produced artificially and the really important regulations, for example concerning hygiene or worker protection standards, are less well enforced despite frequent inspections. This is so because the criteria for getting a license, registration or any other permission is not necessarily adherence to standards but whether or not the business owner agreed to pay enough bribe money. Thus, administrative barriers and corruption seem to be mutually reinforcing and together they decrease the beneficial effect of privatization on the competitive environment.

On the whole, corruption appears to have a double negative effect on *de novo* enterprises, first because it reduces the effectiveness of rules supposed to secure fair competition and second because it further skews fair competition by encouraging the artificial creation of unnecessary entry barriers originating not from incumbent firms but from official authorities themselves.

Anti-corruption laws and policies

The institutional infrastructure controlling corruption differed significantly between Poland and Russia. Specifically, Poland was more determined than Russia to follow anti-corruption policies and to create anti-corruption laws. Frye et al. (1997) draw on a survey of

Polish and Russian shops conducted in 1996. Assessing the economic role of the state during transition, they classify Poland as being described appropriately by the so called ‘invisible hand’ model which is characterized (amongst others) by a government which follows rules, courts that enforce contracts and little overall corruption. For Russia the ‘grabbing hand’ model is found to be most relevant. This model is characterized by a government which considers itself as standing above the law and which uses its power to extract rents. The legal system is ineffective and (disorganized) corruption common.

In Russia, the institutional infrastructure controlling corruption was extremely underdeveloped. The anti-corruption law which was passed only in 1997 (thus long after main privatization efforts) as well as three previous Duma laws were all vetoed by President Yeltsin, mostly on the grounds of unconstitutionality (see UNPAN 1998 country report).

Poland, in contrast, was one of the first transition countries to adopt anti-corruption legislation and corruption there was less widespread than in most other transition countries. (see e.g. The Economist 2001, UNPAN 1998 Country report). The Polish Criminal Code regulates in the Articles 239-245 that bribery and other forms of corruption are crimes. Article 62 of the Budgetary Law specifies sanctions against violators and Articles 65-68 establish investigation commissions (UNPAN 1998 country report). Especially the early years of transition were characterized by relatively more lawfulness and less corruption compared with many other transition countries. In contrast to Russia, Poland tried to actively control corruption, particularly in the early 1990s. For example, it launched the so called ‘Clean hands’ campaign (e.g. Sutch et al. 2000). Even though the program was not particularly successful and only some higher officials were taken away from office, the fact that such a program was launched in Poland and not in Russia is evidence for the relatively higher degree of determination of the Polish government to combat corruption compared to Russian authorities.

On the whole, even though the institutional framework for controlling corruption in Poland in the first half of the 1990s was far from optimal, it was better than in many other transition countries and the government at least showed proof of some degree of commitment to actively combating corruption. In contrast, Russian anti-corruption efforts and infrastructure were almost non-existent or blocked on the highest political levels. Corruption was tolerated and extremely widespread in Russia. For a summary of the main findings see Table 3.7.

Table 3.7: Summary of findings on rule of law

Independent variable: Rule of law		Dependent variable: Relative privatization success	
Selected examples of rules of the game	Findings	Sub-variables	Findings for indicators
Fair competition	Russian competition law neglected areas of cartelization and exclusionary practices whereas the Polish law is commonly assessed as being comprehensive and all-encompassing The wording in the Russian competition law was often very general and left more room for discretion whereas the Polish law was stronger and often included concrete examples of anti-competitive behavior Russian committees lacked relatively more financial resources and expertise Russian criminal penalties were never invoked and fines were rendered unimportant by inflation whereas Polish fines were defined relative to income and maintained their deterrent effect	Competition intensity	Unfair market behavior by incumbent firms was considerably more pronounced in Russia than in Poland; at the same time private *small business density* in Poland was 8-10 times higher than in Russia; thus Polish market was more competitive 30-60 per cent *productivity improvements* in firms that operate in competitive (as opposed to monopolistic markets); at the same time Russian market was more monopolistic relative to the Polish market

Shareholder rights	In Russia very few rules securing shareholder rights whereas in Poland partly protected through 1934 Commercial Code, 1990 Privatization Act and 1994 Act on Accounting Poland performs somewhat better on two of three shareholder rights indices In Russia very poor enforcement and extreme disrespect of shareholder rights culminating in the use of criminal violent means; shareholder protection in Poland somewhat better but difference smaller than expected	Self-dealing	In a sample of start-up firms 35.8 per cent of Russian firms responded that part or all of their *assets originated from state firms* whereas the according number for Polish firms is only 4.2 per cent Between 1996 and 1998 Russia had a negative private *net fixed capital formation* whereas Polish capital formation maintained high positive levels
Anti-corruption	In Russia corruption is considerably more widespread and intense; Poland ranks significantly better on CPI index Poland's "Clean hands" campaign is evidence for a higher degree of political determination to fight corruption Russia had not adopted any comprehensive anti-corruption law by 1995 whereas Poland was one of the first transition countries to adopt anti-corruption legislation	Privatization revenues	Russian *privatization revenues* by 1995 of $1.2 billion are much below reasonable projections with Poland (roughly $3 billion) as a reference point
		Enforcement of rules	Double negative effect of cor-ruption on the small business sector as rules protecting competition are not only not enforced effectively but also turned against some firms, e.g. Russian Antimonopoly committee established non-transparent 'Antimonopoly register'

Source: Own representation

Further general support for the rule of law

Hendley, Murrell, and Ryterman (2000) present apparently paradoxical findings that state ownership and a decrease in competition increases the effectiveness of transactions of Russian enterprises. Their rationale is that ineffective institutions are substituted by alternative mechanisms as a kind of defensive measures for economic survival. As a consequence, this lack of institutions reduces the capacity of reform policies, for example privatization, to yield positive economic results.

Black et al. (2000) note that even basic commercial and capital markets laws did not exist in Russia at the time when voucher privatization was completed in 1994. For example, parts of a new Civil Code, a weak law on securities and a law on joint stock companies were adopted only in 1995-96.

Khodorkovsky, the richest of all Russian oligarchs, admitting that he conducted his business in a careless way said in a recent interview referring to a decade earlier: “Russian law allowed us to do things that were unthinkable in the Western business world.” Berezovski, another Russian tycoon, said: “We didn't break any laws, but if you call giving bribes a crime, then all oligarchs were criminals” (Frontline/World). Even though it would probably be wrong to put too much faith in these statements, they clearly illustrate the very high degree of lawlessness that existed in Russia especially in the first half of the 1990s.

Abstracting a little from the statutory language, when Russian small enterprises were asked about major problems they face, out of eight problem areas legislation was ranked in 1993 as the second most important business impediment and fourth in 1996 (see Radaev 2001). As the sources are unpublished it is impossible to tell which areas of the legislation are meant specifically, but this data again supports the general point of this thesis about the importance that rules of the game must be a priority very early in the transition process.

The above findings show the importance of the interplay between law and enforcement. The overall picture that emerges is that both are crucial but that there is a preponderance of importance of enforcement. The laws in Poland and Russia differ to some extent, but these differences alone do not seem to account for the enormous differences in privatization success. If and how the law is applied and enforced appears to be an even more crucial impediment to successful privatization than the law itself. Differences in the text often seem to be important in that enforcement is weakened because, for example, in Russia the wording leaves more room for interpretation or because other contradicting laws allow circumventing the law legally. Another factor contributing to weaker enforcement of rules in Russia compared to Poland is that controlling and enforcing institutions are less well equipped with skills and financial means. One of the most important impediments for the appropriate enforcement of rules, however, appears to be corruption and organized crime. Corruption seems to be especially important because apparently it does not only directly impact privatization success but also indirectly through significantly reducing the effectiveness of the legal system.

Even though the problem of enforcement of rules is emerging (in this thesis as well as in other research) more and more as the core problem of securing the rule of law in transition countries little attempts have been made to quantify law enforcement, especially for earlier periods of transition. The only index I have found is the 'enforcement' index[18] which mirrors the percentage of firms that responded that they believed that the legal system in their respective country would protect their property rights and enforce their contracts (then in 1999 and three years earlier in 1996). The difference between the responses of Polish and Russian firms is impressive: Whereas, referring to 1996, 70 per cent of the Polish firms articulated a positive opinion on the capacity of the legal system to defend their business rights, the corresponding share of Russian firms is only 25 per cent (Pistor et al. 2000). It would be helpful to have similar data for the areas of regulation examined above. Also, it would be more insightful to have this kind of data for earlier periods of transition, too, to assess better the degree of interaction

[18] This index is based on the Business Environment and Enterprise Performance survey (BEEPS) implemented by the European Bank of Reconstruction and Development (EBRD) in 20 transition countries in 1999.

between privatization and institutions. Nevertheless, this data shows that for 1996 the enforcement situation was assessed to be much better in Poland than in Russia. The difference is so big that it would seem inappropriate to assume that it has been achieved in only one year; rather it can be assumed that the enforcement index would have yielded significantly differing results for Poland and Russia also in earlier years, specifically during main privatization. This is also supported by data presented in previous sections.

On the whole, the hypothesis about the importance of the rule of law for the relatively more successful privatization in Poland compared to Russia cannot be rejected as it is supported by the available data. Correlation is clearly present; causation is likely but the topic is too complex and the available data too limited for any thesis to pretend having ultimately proven a causal relationship.

CHAPTER 4

PRIVATIZATION METHOD IN POLAND AND RUSSIA

The hypothesis developed earlier was that Poland's process of ownership transformation yielded better results than Russia's because the privatization method chosen is associated with an ownership structure that is more likely to contribute to privatization success. In other words, it is hypothesized that in the 4-field matrix Poland will be ranked higher than Russia.

To test this hypothesis I need to find support for the two underlying assumptions of the matrix: First, concentrated ownership tends to yield better results than diffuse ownership. Second, outsider ownership tends to be superior to insider ownership. Much research has centered on these topics. It is frequent in political science as well as in economics not to have an agreed upon consensus on certain questions. There are often theoretical and empirical studies confirming two opposing hypotheses and the here raised question about the optimal privatization method makes no exception in this respect. Therefore, it is not possible to confirm any of the two assumptions beyond any reasonable doubt. From the relatively large amount of empirical studies I can only mention some trying to represent the general tenor of these studies as well as possible. The weight of the evidence shall allow assessing whether the two assumptions are rather supported or not. Studies that synthesize outcomes of an important amount of empirical studies are especially powerful. In a second step, I classify each country according to the matrix. The hypothesis implies that Poland is ranked better on at least one of the two dimensions or on both of them.

Case-by-case privatization versus mass or voucher privatization

The hypothesis above is based on the assumption that case-by-case privatization generally leads to better outcomes than mass privatization because it results in a more concentrated ownership structure. Because of theoretical reasons, concentrated ownership is expected to lead to better micro- and macroeconomic performance. The evidence presented to support or contradict this assumption is drawn from empirical studies on this topic. In addition, I need to find evidence about the role case-by-case and mass privatization played in Poland and Russia.

Discussing the best privatization method, Gray (1996), based on the 'initial weight of evidence', favors voucher privatization[19]. According to Blaszczyk et al. (2004) there are some empirical studies (Linz et al. 1998, Earle et al. 1997) that do not find a consistent relationship between ownership concentration and performance. Grosfeld et al. (2001) examine a sample of Polish enterprises and find that the relationship between ownership concentration and performance is U-shaped. Firms with concentrated (dominant shareholder has more than 50% of voting shares) and dispersed (no investor has more than 20%) ownership are found to show higher productivity increase than firms with a moderate level of concentration.

In contrast, many other studies find a positive non-linear relationship. McConnell et al. (1990) draw on evidence from large European companies and find a positive relationship between ownership concentration and profitability. Weiss et al. (1998) analyze the question for a large number of Czech companies and also conclude that ownership concentration generally has had positive effects. Weiss et al. (1998) and Claessens et al. (1999) while disagreeing on the

[19] Gray's paper is more theoretical in nature and does not contain much empirical data.

importance of concentrated ownership for corporate performance, agree on the point that poor performance of many firms was due to asset-stripping. Cull et al. (2001) note that dispersed ownership, besides lack of regulations and financial incentives, significantly contributed to looting in the Czech Republic because Czech minority owners had little reason to monitor firm assets as they had received the shares virtually for free.

Djankov et al. (2000) is a very important study examining the success of different privatization methods on enterprise restructuring. The conclusions therein contain strong statistical power as the study synthesizes and analyzes the findings of 125 empirical studies. Generally for transition countries, diffuse individual ownership is found to lead to lowest performance of privatized firms and as such does not differ significantly from traditional state ownership. Insiders, bank and commercialized state ownership are clustered in the middle. The best owners are characterized by concentrated ownership with privatization to foreign investors (most effective) found to be roughly ten times as productive as privatization to diffuse individual owners (least effective). For the CIS countries a particularly high and significant positive effect of banks and concentrated ownership is found.

On the whole, the conclusions of a majority of the surveyed studies support the assumption that concentrated ownership tends to be more effective than diffuse ownership. Therefore, case-by-case privatization appears to indeed yield better results than mass privatization. Again it shall be noted that the weight of evidence seems only to support the assumption, but it cannot be regarded as a fact. Therefore, all further conclusions must be treated cautiously. Which privatization path, however, did Poland and Russia choose?

At the end of 1989, the Mazowiecki government in Poland rejected a plan for mass privatization and adopted the case-by-case principle. Direct or indirect sale of companies has been the most utilized privatization procedure in Poland (see Baltowski et al. 2000, Blaszczyk 1999, Aussenegg 1999). This was especially so in the here relevant period from the main start of the Polish privatization process in 1991 until 1995. It is only from the second half of 1995 that the government began to put more effort into voucher privatization through the so called NIF program[20]. According to Blaszczyk to find and to choose the "best possible investors for the different types of enterprises being privatized" was the underlying principle that guided Polish privatization from the start (p. 18). This is coherent with the finding in Frydman et al. (1997) that a large majority of Polish mid-sized companies they survey had a dominant shareholder with an average stake of 50-80 per cent.

In stark contrast to Poland, Russia launched a mass privatization program from 1992-1994/95. According to Boycko et al. (1993) the principal way in which company shares were sold was through auctions of shares for vouchers. For a small fee of 25 ruble (5 cents at the prevailing exchange rate) every Russian was given the opportunity to buy a privatization voucher with a denomination of 10,000 ruble ($ 20) which could be used to acquire company shares. Clearly, the beneficial social effect of such a voucher, even considering the low standard in Russia, is negligible. Due to political pressures, insiders were given special concessions. Not only were the options for insiders designed very generous (see below) but the voucher privatization realized in Russia is assessed as a big concession by the government in the sense that it did not impose large shareholders on the firms which led to the managers being highly independent. Megginson et al. (1999) note that most countries have had negative experience with voucher privatization but that none was quite as miserable as Russia's. Hopes of the government

[20] The NIF (National Investment Fund) program was applied in 1995-96 to about ten per cent of public assets in order to accelerate the privatization process. It is not regarded as particularly successful (see Blaszczyk 1999).

that voucher privatization funds would overcome the collective action problem by using their concentrated ownership to influence management behavior toward restructuring did not materialize because these efforts were completely blocked by insider dominance.

To summarize until now: The assumption about the superiority of case-by-case privatization over mass privatization for economic success seems to be supported by empirical work. At the same time the evidence suggests that until 1995 Poland's privatization process can be *predominantly* characterized by the case-by-case principle whereas ownership transformation in Russia until 1995 followed *predominantly* the principle of mass privatization.

Privatization to outsiders versus privatization to insiders

The second assumption on which the hypothesis above is based is that privatization to outsiders is more effective than privatization to insiders. Again, I need to present empirical evidence to verify this assumption and to examine to what extent Poland and Russia differed in terms of ownership type.

Djankov et al. (2000) find that outsider privatization is associated with 50% more restructuring than insider privatization.[21] On the question whether new human capital is associated with better performance they find statistical evidence which supports this hypothesis for both CIS and non-CIS countries. This result corresponds to the findings in other studies that management turnover in privatized firms is associated with roughly 6-7 per cent increase in labor productivity (Claessens et al. 1999, Hessel et al. 1998 as cited in Djankov et al. 2000).

[21] Interestingly, Djankov et al. (2000) also find that manager ownership is more effective than worker ownership which implies that it may be helpful to differentiate among insiders, something that is not done to the necessary extent in many other studies. Because privatization method is not the only topic of this thesis, I can not go too much into the detailed level of different types of owners (managers, employees, funds, banks, foreign owners, etc.). The distinction between managers and workers shall be subject of more focused papers than this thesis.

Based on a 1994 survey of 506 medium-sized firms in Poland, Hungary and the Czech Republic, Frydman et al. (1999) draw the central conclusion that the performance effect of privatization is significantly different depending on the type of owner to whom control is given. More specifically, they find that privatization has a pronounced beneficial effect on firms with outsider owners but no effect on firms with insider ownership. Firms with insider ownership are found not to differ significantly in performance from state firms. Megginson et al. (1999) survey important studies on this topic (including the previous study) and find that these are consistently pointing into the direction that in Eastern European countries majority ownership by outside investors is associated with significantly greater performance improvements than any form of insider control. Outsider-controlled firms are found to be more likely to restructure which is associated with higher performance after privatization. It is also noted that most surveyed studies document higher performance improvements when new managers are brought into the company.

Baltowski et al. (2000) drawing on evidence from Poland, conclude that positive privatization effects on restructuring depend on the resulting ownership structure. Companies that are owned by a strategic investor showed better results than companies leased by their employees. Similarly, Blaszczyk (1999) finds that sales to strategic investors as well as public share offerings were the most successful in Poland in terms of good economic performance. Second-best but still successful were management and employee buyouts whereas voucher privatization yielded rather negative results. Megginson et al. (1999) surveying studies about the former Soviet Union find that privatization effects are highest in firms controlled by outsiders. Again, the importance of new managers is pointed out.

The second assumption that outsider ownership results in more privatization success than insider ownership is supported by a large majority of the surveyed empirical studies on this topic.

In order to be able to classify both countries, we must ask to whom, insiders or outsiders, were companies privatized predominantly.

Many transition countries have tried to ‘buy’ acceptance for the privatization program by offering preferential terms to managers and employees. Russia is one of the countries that went very far in this respect. Enterprise insiders were given control of about seventy per cent of privatized firms, mostly through voucher privatization (Frydman et al. 1999, Black et al. 2000). Managers and employees were offered three (voucher) privatization options all of which transferred an important share of the company to insiders for a very low price. The option which gave insiders most control over a company (51 per cent of equity and thus voting control) was chosen most frequently (see for example Boycko et al. 1993). According to Earle (1998), however, insider-owned firms in Russia did not substantially improve performance. Similarly, Megginson et al. (1999) find that the surveyed empirical studies about the CIS countries yield consistent results: Insider privatization in CIS countries, especially in Russia, has failed. Insider buyouts in Russia also are found to have led to a high degree of managerial and worker entrenchment. Managers often imposed on workers not to sell shares to outsiders or even succeeded through dubious methods to acquire a larger share of the company, often in order to eliminate any resistance against looting of the company (Gray 1996, Black et al. 2000).

The finding that the Russian privatization process was very much directed toward insiders together with the above finding that until 1995 vouchers were used much more frequently than case-by-case sales, seems to justify the assessment that field (IV), voucher privatization to insiders, best describes the primary privatization method in Russia.

Interestingly, in Poland the ownership of a large part of enterprises was also transformed to insiders. The 1990 Polish privatization law provided preferential treatment of insiders. In the case of capital privatization employees had the right to acquire 20 per cent of the shares at 50 per cent of the issue price. If a company was privatized directly employees were given priority over all other bidders (see Gorzynski et al. 2000). Because the studies I found generally look only at a sample of firms, I do not have exact data on the question which owner type dominated in the Polish companies that were privatized until 1995. Vinton (1993) presents data that by March 1993, 2,149 Polish state firms had embarked on privatization out of which 491 were commercialized. With assets bought from part of the remaining 1,658 state firms which underwent direct privatization, 463 new companies with insider control were formed. Blaszczyk (2004) notes that by the end of 1998 lease-leveraged employee buyouts accounted for about one third of the completed privatizations. From these numbers it is still not clear exactly what proportion of the privatized firms went to insider control, but the general sense these numbers together with the consulted literature invoke is that there was no predominant owner type in Poland. Outsider ownership in Poland was more frequent than in Russia. Insider ownership played an important role in Poland too, but not as much as in Russia. On the whole, the relation insider to outsider ownership was more balanced in Poland than in Russia, but I cannot identify one predominant owner type.

Therefore, it is difficult to assign Poland to one of the four fields. Poland's privatization was a mixture on the second dimension and together with the finding from above about the preference for the case-by-case approach, Poland's privatization method might be best described as being between field I and field II.

Figure 4.1 is supposed to show graphically the general trend of the path of privatization chosen by Poland and Russia between 1991 and 1995. The circles are not derived with vigorous scientific methods and shall not be interpreted literally. In both countries there are, of course, a certain number of privatizations that have been carried out in a way that would lead to a different classification. The circles introduced do explicitly not stand for *all* privatizations. They are rather supposed to illustrate what has been said earlier about the *general tendency* of privatization method in each of the two countries.

Privatization method		Privatization method - technical - (Ownership concentration)	
		predominantly **Case-by-case privatization** (Concentrated ownership)	*predominantly* **Mass privatization** (Diffuse ownership)
Privatization method - target group - (Basic owner type)	*predominantly* **to outsiders**	I Poland	III
	predominantly **to insiders**	II	Russia

Figure 4.1: Two main dimensions of privatization method in Poland and Russia (1991-1995)

On the whole, the numerous studies on this subject generally support the assumption that the method of ownership transformation has an important impact on privatization success. In particular, the two assumptions, which are the basis for the above presented ranking of the four fields (I, II, III, IV), are supported by most of the surveyed literature. For example, much of the evidence points to the sale to strategic investors, especially foreign owners, as leading to the best privatization outcome. This is exactly in accordance with expectations of the 4-field-matrix that field (I) is the optimal combination. At the same time, the examination of the privatization methods used in Poland and Russia and the subsequent classification of the two countries yielded results consistent with the hypothesis.

There is positive correlation between privatization method and all four indicators of the dependent variable small business density, productivity improvement, looting and privatization revenues as Poland performed better on all of these indicators (as shown earlier) and at the same time chose a privatization method that was assumed to lead to better outcomes. However, correlation does not mean causation and there is also some evidence suggesting that the relationship of ownership structure and privatization success is *in part* spurious. Many root causes of the problems with voucher privatization can be traced back to the absence of controlling institutions. Russian managers, for example, who were not effectively threatened by legal sanctions, often used company funds to buy vouchers in order to gain control over a bigger share of the company (Black et al. 2000). Even though it can be argued that voucher privatization with a high insider involvement indirectly encouraged looting of company funds in order to acquire company control, this kind of criminal behavior is less likely to appear on a massive scale as it did in Russia if a legal framework is enforced effectively. No law can oblige managers to do an optimal job in increasing efficiency and value of the enterprise, but the law can restrict insider behavior such as looting that damages the enterprise for private gains. The former is related to the question which incentives are faced by insiders which is in part dependent on ownership structure and thus on privatization method (non-spurious relationship), the latter, however, only appears to be related to ownership structure but can in essence be traced back to missing institutional infrastructure (spurious relationship).

Another example: one reason why diffuse ownership performs least well in terms of productivity improvement may be the lack of controlling institutions protecting shareholder interests and the ability of shareholders to exercise pressure on the management to improve efficiency. While in the highly developed industrial nations diffuse ownership works because investor rights are legally secured and enforced by different 'watchdogs', the institutional infrastructure was suboptimal in Poland and much worse, almost non-existent, in Russia. If there is indeed causal relationship, then the real reason for bad performance would not be as much voucher privatization as the lack of institutions protecting shareholder rights. In Pistor (2000) it is noted that the attempt in transition countries pursuing mass privatization to fundamentally change the ownership structure and governance of firms has been seriously undermined because of the failure to provide effective minority shareholder protection in advance.

A third example: Megginson et al. (1999) note that Russian citizens have become owners of the worst performing privatized assets while the most profitable firms have all come under insider control. If we assume that one reason for this skewed privatization outcome may be corruption, and as shown above there is enough reason to believe that this assumption is justified, then due to the correlation it would only seem that there is a causal relationship between voucher privatization and bad performing firms while the real reason for performance differences is not the privatization method but irregular and unfair privatization practices (e.g. while choosing the privatization objects) due to corruption – a corruption-induced selection bias.

However, in terms of explaining differences in privatization revenues, a counter example diminishing the explanatory power of corruption and strengthening the explanatory power of privatization method can be given: Looking at the generated privatization revenues, the voucher privatization method in Russia may have had indeed a negative effect as a big proportion of state assets have been given away cheaply and thus the earlier asserted relationship between corruption and privatization revenues may *in part* be spurious. The fact that Russian privatization revenues increased after 1995 when case-by-case privatization became more common while corruption maintained high levels supports this point, too. Thus, in the case of privatization revenues it seems that the privatization method accounts for a part of the observed differences. However, in the cases of direct or indirect sale of assets much below market value for which there are much more numerous and extreme examples in Russia compared to Poland (see e.g. Black et al. 2000) a positive relationship between corruption and revenues still appears very likely.

A fourth and last example: Case-by-case privatization may not only lead to more success because concentrated ownership is more effective but also because it also implies a slower pace of ownership transformation. This slower pace of privatization allows the creation of the regulatory framework necessary for the forming of effective markets in which all actors must abide to the rule of law so that privatization benefits society as a whole and not just very few.

Djankov et al. (2000) present powerful empirical evidence suggesting that the degree to which type of ownership affects performance is partly dependent on institutions. They note that corporate governance institutions function less well in CIS than in other transition countries and argue that there will be more variation in the importance of ownership effects where corporate governance institutions are weak. Examining this kind of argumentation by comparing the results of an important number of studies on this subject, they find statistical evidence that the differences in effectiveness of various ownership types are indeed more important in the CIS. For example, they note that the effect of concentrated ownership is not only positive but also significantly stronger in the CIS countries than in Central and Eastern Europe and explain this difference in part by less well-functioning institutions in the CIS. If their argumentation indeed reflects reality than it would diminish (not necessarily eliminate) the importance of the method of ownership transformation for privatization success and add support for the importance of institutions because the existence of effective institutions would be expected to reduce the significance of the chosen method of ownership transformation on privatization success.

The hypothesis that Poland's privatization efforts yielded better successes because methods of ownership transformation were chosen which are associated with an ownership structure, namely higher ownership concentration and outsider control, that is more likely to lead to privatization success could not be rejected. Privatization method is correlated with all four indicators of the dependent variable but causal relationship cannot be rigorously proven. Even though privatization method and small business density are correlated, no evidence could be found to support causal relationship. Privatization method seems however to be likely to influence the other three indicators. It appears that privatization method may have a more pronounced causal relationship with productivity improvement and privatization revenues. The relationship with looting appears to be *at least partly* spurious.

CHAPTER 5

CONCLUSION

Discussion

The issue is not simply shock therapy versus gradualism. Reducing the discussion about successful transformation to “shock therapists” against “gradualists” tends to oversimplify. Instead of looking at the various reform measures as a whole and to discuss whether they should be realized more rapidly or more slowly, it seems more reasonable to break down the reform measures and to ask which sequence of policies is the most appropriate. The outcomes of this thesis support the view that it is more the question of realizing the right reform measures at the right time, thus a question of phasing. This phasing of reform measures should not be delayed unnecessarily, but at the same time it must be adapted to the particular situation in the individual country and where necessary a gradual approach to certain reform measures such as privatization seems more appropriate so that other necessary preconditions which may not exist yet can first be built.

The Russian example raises serious doubts that the ‘one size fits all’ approach proposed by the Washington Consensus is appropriate for resolving the deep economic problems in all former socialist transition countries. Just as any company, to use an analogy, that finds itself in a difficult business situation is better served if the Consulting firm comes up with a very individual and well thought through strategy as opposed to standard advise, transition countries also need an individual strategy of transformation which adapts generally acknowledged economic insights to the particular situation. This point has been discussed in depth in Wade Jacoby's *Imitation and Politics* (2000) in the context of Germany. While in the after war period the Allied forces encouraged the creation of institutions that were functionally similar to the ones they had at home, they were also careful to involve German organizations where possible which allowed the resulting institutional infrastructure to be better adapted to the particularities of German society. Some decades later, however, West Germany imposed exact imitation on Eastern Germany while the outcomes were less favorable. This does not mean that a new consensus applicable to most transition countries is impossible but even with this consensus, transition strategies must be adapted to the particularities of each individual country because there are too many uncontrollable but important factors such as history, culture, initial conditions, etc. that might diminish the success potential of any 'one size fits all' approach. In the case of the Russian privatization process, much of the evidence suggests that from the very beginning a high priority should have been creating the institutional framework necessary for a functioning market economy instead of rapidly privatizing first and doing irreversible damage to the national economy.

Proponents of rapid privatization argue that in Russia there was a trade-off between bad privatization (private monopolies, bankruptcies, etc) and reversal of reforms due to a political environment that was hostile to reforms. They also argue that illegal, so called 'spontaneous' privatization took place even before official privatization and that companies would have been looted either way (see e.g. Joskow et al. 1994). So, did rapid privatization in Russia make things worse?

The answer to this question is difficult as the actual development must be compared to a counterfactual if privatization would have happened more gradually. Some, for example Black et al. (2000) and Hoff et al. (2002) are clearly affirmative. One central point in Hoff et al. is that view the lack of institutions, official (compared to spontaneous) privatization enhanced further insiders' ability to strip assets. Another important point they make is that the 'big bang' approach in Russia may have contributed to delaying the establishment of the rule of law.

In retrospective it is difficult to assess the likelihood of the counterfactual that reforms in Russia would have been reversed if privatization was not executed radically. Fact is that the way reforms were implemented in Russia significantly increased mistrust and resistance among the Russian population toward further reform. Most Russians perceive the early privatization program as a legalized theft on a big scale which benefited only a small group of privileged people.

Even *if* rapid privatization did not make things worse, the least that can be argued is that the way ownership transformation was carried out in Russia (with the sole focus on speed neglecting the importance of institutions), it did not make things any better either. At the same time scarce political resources were used to plan and execute rapidly the privatization plan, human and financial resources that could have been used to faster create an effective regulatory framework in order to lay the grounds for a more successful privatization and to begin effectively counter-acting earlier whatever theft occurred even before privatization. The priorities were wrong.

A comparison between Russia and Ukraine shows that if a government is badly enough corrupted and incapable, rapid mass privatization does not make a big difference (see for example Black et al. 2000). Concluding that because theft would have occurred even without privatization it was good to speed up the process of ownership transformation is not plausible. Instead of overly emphasizing speed of liberalization reforms, the Western advisors and financial institutions such as the World Bank, the International Monetary Fund or the European Bank of Reconstruction and Development should have put at least as much emphasis on the recreation and extension of the regulatory framework so that the governments of transition countries could understand earlier the absolute crucial importance of rapidly filling up the institutional vacuum which had led to widespread lawlessness. Government financial and human resources are scarce. Therefore, doing the most important things in the individually right order is the key to successful transformation.

In contrast, exactly in countries where institutions and the rule of law were weak the emphasis on liberalization and privatization was strongest reflecting an idealistic, almost ideological belief by policy makers and advisors that the market, the invisible hand, would fix things and market-supporting institutions would somehow emerge from the ruins of post-socialist reality. These hopes did not materialize. North (1997) notes critically about neo-classical economic theorists:

> *(…) few Western economists understand the institutional requirements essential to the creation of (…) markets since they simply take them for granted.*
>
> North 1997, p. 2

In a similar spirit Nellis (1999) notes:

> *The international financial institutions must bear some of the responsibility for these poor outcomes, since (…) they requested and required transition governments to privatize rapidly and extensively, assuming that private ownership by itself would provide sufficient incentives to shareholders to monitor managerial behavior and push firms to good performance. Competitive policies and institutional safeguards could follow at a later date; the key need was to create a basic constituency of property owners. The prime assumption was that to build capitalism, one needed capitalists; lots of them, and fast.*
>
> Nellis 1999, p. 16

In my opinion proponents of fast and radical privatization in Russia committed an important logical error. They either wrongly believed that “the rules of the game” (and their efficient enforcement) are already in place or they assumed that these will somehow be created as a necessary consequence of the liberalization policies and the pressures they produce on the state. Whereas some former advisors and proponents of fast and radical reforms à la Washington Consensus (e.g. A. Aslund) continue to insist on their mantra: “Privatize and liberalize as fast and radical as possible”, others (e.g. J. Sachs) today admit themselves that they were wrong.

At a Warsaw symposium, Sachs said that he wrongly advocated mass privatization in Poland and that he miscalculated the potential for corruption in Russia. According to Sachs, Poland made the right decision not to follow his advice in 1990 and to delay mass privatization. On the other side, in Russia, the state-owned firms “did less badly than I'd thought. I had thought it would be just rape and pillage – and it wasn't.” Sachs admitted that he completely underestimated “the depth of the corruption that happened with mass privatization in Russia and the Czech Republic” (as cited in Pagacz 2000).

The highly respected Nobel Prize recipient Milton Friedman highlighted the importance of legal structure for prosperity at the 2001 annual meeting of the Economic Freedom of the World Network held in San Francisco by admitting:

> *Just after the Berlin Wall fell and the Soviet Union collapsed, I used to be asked a lot: “What do these ex-communist states have to do in order to become market economies?” And I used to say: “You can describe that in three words: privatize, privatize, privatize.” But, I was wrong. That wasn't enough. The example of Russia shows that. Russia privatized but in a way that created private monopolies – private centralized economic controls that replaced government's centralized controls. It turns out that the rule of law is probably more basic than privatization. Privatization is meaningless if you don't have the rule of law. What does it mean to privatize if you do not have security of property, if you can't use your property as you want to?*
>
> Friedman as cited in Gwartney et al. (2003), endnotes, p. 12

It is only since the significance of the rule of law and institutions in general for successful privatization as well as for overall transformation success is more and more realized that Western organizations pay significantly more attention to these issues as opposed to merely emphasizing liberalization. Governments of lagging transition countries such as Russia, Balkan and Caucasus countries seem to slowly realize that institution-building must become a top priority.

Outcomes

> *Initial conditions, especially the quality of institutions, matter more (…) than we thought in the early 1990s.*
>
> Black et al. 2000, p. 1802

Both hypotheses are supported by empirical evidence. It appears that both, the method of ownership transformation and the rule of law influence the success of privatization. The hypothesis that Poland's privatization yielded better results because the with the chosen privatization method associated ownership structure contributed to more privatization success could not be rejected. However, the assumed positive effect of privatization method appears to be better supported in terms of productivity improvements and privatization revenues. The correlation between privatization method and the other indicators of the dependent variable has been suggested to be *in part* spurious but could not be demonstrated with rigor because of time and space constraints. In contrast to the second dimension (insider versus outsider), the first dimension is related to speed of privatization. Case-by-case privatization is a slower method of ownership transformation.

The hypothesis about the importance of the rule of law for successful privatization is supported by empirical evidence as well. The rule of law is correlated with all four indicators as expected and causal relationship is likely but cannot be proven beyond reasonable doubt.

Both results point into the same direction and are in odds with neo-liberal argumentation that high speed of privatization always leads to better outcomes. Therefore, both explanations may be seen as two good candidates for resolving the puzzle.

In terms of assessing the weight of each of the two explanations, it has been suggested that part of the explanatory power of privatization method may in fact originate in the competing institutional explanation. Some examples are offered that suggest that voucher privatization may not only be less effective by itself but, in part, also because the lack of an effective institutional framework such as shareholder rights, anti-corruption law and prosecuting institutions further reduces the positive effects. Poland may have been successful with the case-by-case method not only because of the advantages of concentrated ownership but also because this method allowed more time for creating the conditions necessary for privatization success. View that there are good reasons to believe that the effectiveness of different privatization methods may partly depend on the rule of law, it seems justified to argue that the often neglected role of an effectively enforced regulatory framework for successful privatization is (at least) similarly important as the ownership transformation method and consequently deserves equal attention.

These outcomes imply that a more holistic view on the privatization process in transition countries may be appropriate. Dominance of private property alone is not enough for a functioning market economy and transformational success. Shock therapists focused solely on speed of liberalization reforms and neglected other factors that appear also to be important – one of these are effective institutions securing the rule of law.

Limits of this thesis and suggestions for further research

In the following, I want to briefly discuss the major limits of this thesis and suggest some possible areas for further research. First, by choosing a two-case study it is not possible to generalize conclusions. Conclusions of this thesis are only applicable to the two countries Poland and Russia. Empirical studies examining the importance of institutions for a number of transition countries are necessary for generalizations. Second, I had to rely on historical data which was partly difficult to obtain. The general underestimation of the importance of institutions for the privatization as well as the whole transformation process in transition countries is reflected by a very limited amount of studies on this particular topic. Thus, some data that might have further strengthened an argument was simply impossible to find. Third, as mentioned earlier, only two out of a number of possible explanations have been examined. Thus, even if such a more focused study may contribute a small piece, the many pieces have yet to be put together to indeed solve the puzzle.

Obviously, more research is necessary on the role of institutions in the transition process. Assuming that the majority of further research confirms the crucial importance of institutions, the next very important question that arises then is why exist there such important institutional differences between countries? A possible explanation might be a combination of differences in history and mentality. Besides time constraints, one reason for not including this explanation as an independent variable in the main part of this thesis is that it is not conceptionally on the same level as the independent variables. It is not considered to compete with the independent variables but to be located one step earlier in the causal order. The author of this thesis thinks that it would be misleading to ask whether it is institutions *or* history that determines privatization success. Rather than perceiving these as two distinct explanations for privatization success, it seems more appropriate to see them as linked in a causal chain. Historical legacy may be one important explanation why Poland had better institutions than Russia. For example, Poland has, in contrast to Russia, a tradition of a well-developed legal and institutional framework including the protection of the market (see e.g. Gray et al. 1991, Solomon 1999). This tradition was partly preserved even under communist rule. When Poland started its reform process it could build on its experience. Poland also was always "a little more capitalistic" compared to the Soviet Union. Poland's agricultural sector, for example, remained largely in private hands during the communist rule. As soon as 1981, under important pressure from the 'Solidarnost' movement, the communist authorities allowed the workers to substantially participate in corporate decision-making which increased the degree of self-management of SOEs (see Schöllmann 2001). Thus, the fact that one of Poland's major priorities during transition was to build effective institutions may be explainable by historic factors such as old Polish traditions on the one hand and some degree of experience of the Polish people with capitalism contributing to the immediate awareness about the significance of institutions for the functioning of competitive markets. Examining the role historic legacies and other factors might have on institutional infrastructure of transition countries appears important.

The evidence presented above supports the view that institutions are very important for successful privatization. If effective institutions are not in place it appears reasonable to begin with institution-building (and -preservation) very early in the transition process to create the bases for further reforms and economic growth. The pace of formal institutional change must, however, take into account informal institutions. Murrell (1993) speaks of a "trade-off between the best formal rules and those that society is able to use and to support". Tomer (2002) argues that the so called 'soft factors' (attitudes, behaviors, values and beliefs), which basically resemble much to North's first institutional dimension (see Chapter 2) and the system must change in a compatible way in order for the transformation to be successful. However, one might argue that sometimes, in extraordinary situations such as the lawlessness in Russia in the early 1990s, formal institutional change can and should sometimes lead the change of informal constraints. For example, strong emphasis of government policy on law and order may rapidly be accepted and welcomed by an overwhelming part of the population and thus reduce societal tolerance for individual behavior that damages the community. It is the majority of the people who benefit from well-designed institutions and not surprisingly the call for law and order and elimination of corruption is and has always been since the beginning of transition among the most important demands of citizens of post-socialist countries[22]. Clarifying the question to what extent the building of formal institutions can lead change in informal institutions in transition countries may further improve our understanding of successful transformation.

Levels of social capital and trust in these countries are generally low (see Lovell, 2001) and it may be tenting to argue that this was one important reason for the inability of some countries, such as Russia, to establish an effective institutional framework securing law and order. However, it may also be argued from a different perspective that the lack of social capital is not a cause but an effect of the lack of institutions and that more of whatever trust existed in these societies could have been preserved and deepened if the crucial importance of institutions was recognized (by domestic policy makers as well as by foreign advisors) from the very beginning of the transition process. If this argumentation happens to mirror reality then one important consequence would be that exactly these transition countries with the biggest decline in institutional infrastructure should have worked all the more on preserving and rapidly

[22] This assessment is based on personal experience as a citizen of a former socialist country

recreating a regulatory framework immediately after the change, only that this time such a framework would have been governed (in the economic sense) not by socialist but by market principles.

The questions raised above are to illustrate some, in my view, interesting areas for further research which may potentially increase our understanding about successful privatization and overall transition. Answering the questions to what extent institutions matter for transformational success, what explains different levels of institutional infrastructure across transition countries and how higher levels can be achieved seems crucial for advancing the debate on successful transformation. More research should focus on this domain.

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