

Political Thugs: Criminal Corporate Raiding and Property Rights in Early-Capitalist
Eastern Europe

by

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Abstract

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Based on evidence from Estonia, Poland, Slovakia, and Ukraine, this dissertation explains variations across post-communist countries in the frequency of criminal corporate raiding and the effectiveness of property-rights institutions. A *criminal corporate raid* is the takeover of a private business through the use of force, whether by means of direct violence or the help of the state. I examine raiding among two segments of the business elite: the *plutocratic* stratum, consisting of the twenty richest individuals, and the *non-plutocratic* elite, which refers to relatively less wealthy businesspeople along with state officials engaged in private business. Ukraine and Slovakia display extensive raiding among both the plutocratic and non-plutocratic elites. In Poland, raiding is just as pervasive within the non-plutocratic elite but rarer among the plutocrats. Estonia exhibits little raiding among both elite groups. The high incidence of raiding in Ukraine, Slovakia, and Poland means that property-rights institutions are by definition not doing their job. Only Estonia managed to develop a set of robust property-rights institutions, a fact supported by dozens of interviews with state officials. These findings fundamentally contradict much of the literature, which regards Slovakia and especially Poland as among the post-communist leaders in developing sound, market-supporting institutions. Instead, this investigation uncovered shocking and systematic abuses of property rights in both countries of a kind typically seen as restricted to places like Russia and Ukraine.

The reasons behind these variant outcomes boil down to one key factor: the extent to which early post-communist governments imposed hard budget constraints on business actors. Budget constraints are said to be hard when firms cannot access artificial external support in the conduct of their business. They are soft when firms receive external assistance not justified by economic rationality. In Poland, Slovakia, and Ukraine, governments did not go far enough in reining in soft budget constraints; emerging business actors benefited from a proliferation of direct transfers from the state budget, illicitly subsidized privatizations, overpriced state contracts, cronyist financing from banks, advantageous price controls, and one-sided transactions with state enterprises. Soft budget constraints ended up enriching and empowering a class of *political thugs* whose comparative advantage lay solely in their political connections, not

their capacity for productive economic activity. Having accumulated their initial fortunes by stealing state assets, it was a natural and logical step to begin stealing them from others in the form of raiding. Poland differed from Slovakia and Ukraine to the extent that its biggest state enterprises were largely sold at market prices. This accounts for the lower proportion of political thugs among its plutocratic elite and, in turn, the lesser incidence of raiding in this stratum. Beyond that, however, soft budget constraints were widely available there. This explains why the non-plutocratic elite in Poland is filled with political thugs. Estonia avoided these outcomes thanks to the swift and radical imposition of hard budget constraints in the early 1990s. This cleared away potential opponents to the establishment of effective property rights institutions.

The current fashion in much of social science is to look at how institutions shape actors. This mode of inquiry is obviously important and useful. But it has led specialists to give what may very well be mistaken advice to policymakers: change the rules, and the actors will behave in ways better suited to a functioning market economy. The evidence uncovered here suggests that attempts to build market-supporting institutions, however well-intentioned, will likely fail if powerful economic criminals have a large presence.

If the goal is to construct well-functioning state and market institutions, we would be well-served by examining not only how institutions affect actors but also the ways actors shape institutions. This study does both. It first shows how hard budget constraints – which consist of certain key policies and institutions – can help sideline economic predators. It then goes one step further, examining how the presence or absence of powerful groups of economic criminals determines the prospects that effective property rights institutions can emerge.

Theories of institutional origination generally fail to identify the precise ways that governments can undercut the power of criminal business actors opposed to the status quo. This study not only corrects for these shortcomings but provides a clear lesson to policymakers in early-capitalist countries who are interested in building property rights institutions; by hardening budget constraints, reformers can fatally undermine the political thugs acting as a constraint on institutional development.

If specialists disagree on whether policies or institutions are more important in creating market economies, hard budget constraints involve some of both. But they hardly encompass all of both. What they do offer resource-constrained policymakers is greater bang for their buck; by weakening corrupt actors committed to the status-quo, hard budget constraints can open the way for the construction of a much broader array of market-supporting institutions.

to Mom, Dad, and Ben

&

to Judith

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It goes without saying that any flaws and shortcomings that remain are entirely my own.

“We’re not allowed to cover it. They don’t like all the money and the yachts.”

—Employee of a major Russian state TV network, when asked why it devotes so little coverage to the ongoing court battle in London between Russian oligarchs Boris Berezovsky and Roman Abramovich.¹

“I can kill someone with this ring.”

—Vladimir Putin’s parting shot to New England Patriots owner Robert Kraft. Kraft alleges that, after showing Putin his Super Bowl ring, the Russian President became enamored with it, “put it in his pocket, and three KGB guys got around him and walked out.”²

“Count my balls.”

—Adrian Năstase, the Romanian prime minister, to a parliamentary deputy after the deputy demanded that Năstase account for how he manages such an extravagant lifestyle.³

Chapter One

Introduction

In any society, especially one in the throes of early capitalism, there are two sides to politics. There is the official side, in which governments and leaders issue programmatic appeals ostensibly designed to promote the broader good – more state regulation of the economy or less, the expansion of the welfare state or its retrenchment, closer EU integration or euroskepticism, and the obligatory, self-aggrandizing “anti-corruption campaign.”

There is, however, a second side to politics in the early-capitalist country: a criminal, subterranean underbelly in which the main preoccupation of the powerful is not the pursuit of official policy goals but rather the illicit acquisition of wealth. It is this latter political universe that provides the focus of the current study.

¹ Neil Buckley, "Russians in London: Super-Rich in Court," *Financial Times*, 7 October 2011

² The Reliable Source, "Vladimir Putin Denies Stealing Super Bowl Ring," *The Washington Post*, 16 June 2013.

³ Neil Buckley, "Romania: A Balkan Imbroglia," *Financial Times*, 12 August 2012.

The two sides to politics – official and illicit – have a peculiar relationship with one another. What often stands behind one programmatic appeal or another in an early-capitalist environment is a sly attempt by the powerful to exploit such policies to amass wealth for themselves, all the while portraying their efforts a blessing for the country. For whatever policy goal they publicly support, their real agenda is often to make money out of it – if not for themselves, then for the allies whose support is so crucial to helping them gain and maintain power. As Dorel Sandor, a Romanian political analyst, aptly observes, “[f]or the last 20 years, we have had a most important evolution: the rediscovery of money. All the other things – freedom, competition, democracy – are only instruments to accumulate power and make money.”⁴ Using power to acquire wealth – that is what the game is really about.

The three epigrams above provide some indication of the mindset of the new post-communist elite. On the one hand, its members are preoccupied with concealing their wealth amidst an embarrassment of private riches illicitly obtained. At the same time, they are entirely unapologetic in their sense of entitlement to “live off the land” and take what they please as if they were medieval aristocrats. Messrs. Berezovsky and Abramovich are private businessmen. And yet the Kremlin, which has no official ties to either individual, is obviously worried that the mere image of their extravagant lifestyles broadcast across the country’s television screens might lead ordinary Russians to ask some uncomfortable questions. Such questions would not only concern the rather nefarious means these businessmen used, invariably with the illicit collusion of the Russian government, to acquire their wealth in the first place. They could just as easily be directed toward the lavish lifestyles enjoyed by Kremlin officials and, indeed, Putin himself, with his alleged personal fortune of \$40 billion.⁵

In this criminal underground world, the pursuit of power for the sake of wealth remains hidden from public view. The quotations above reveal just how much the powerful wish to keep it that way. The citizens of these countries are too smart to remain oblivious to its existence. But many are necessarily ignorant of exactly who got what and how in the epic struggle for post-communist riches.

Many crusading reporters have risked their lives to bring this universe into the light of day. In doing so, they have often succeeded in cutting down to size the extraordinarily venal politicians, state officials, and businesspeople who make a living from booty extracted from others. Given the limitations imposed by language, public awareness of these spectacular exposés tends to remain confined to the countries in which they are published. The current investigation, standing often on the shoulders of these brave reporters, aims to pry into this criminal world, analyze how it differently manifests itself across countries, and bring it to the attention of Western social scientists.

This investigation specifically focuses on a particular form of criminal wealth acquisition in early capitalism: the use of strong-arm tactics to take over private businesses, or what I will refer to as *criminal corporate raiding*. We will try to

⁴ Buckley, “Romania.”

⁵ The estimate is as of 2007. Stanislav Belkovskii, the Moscow-based expert who made the estimate, says of Putin’s alleged wealth that “It’s not a secret among the elites. But please pay attention that Vladimir Vladimirovich [Putin] has never sued me.” Luke Harding, “Putin, the Kremlin Power Struggle and the \$40bn Fortune,” *The Guardian*, 20 December 2007. Also see Wikileaks cable: “Us Embassy Cables: Putin’s Links to Russia’s Oil Trade,” *The Guardian*, 1 December 2010.

understand why this phenomenon is more frequent in some post-communist countries than others and why only certain countries have managed to build property rights institutions capable of reining it in.

This study complements the growing literature on predatory economic behavior on the part of political and business actors.⁶ It also raises profound questions about the currently prevailing wisdom on both the origins and consequences of property rights institutions. To begin with, it aims to explicitly problematize the widely-held assumption that legal property rights protections are a necessary precondition for sustained economic growth.

Rather than the effects of these institutions, however, the primary focus of this study will be on their origins. Most accounts of the conditions under which property rights institutions arise cannot sufficiently explain when and how reformist governments are able to marginalize powerful societal actors opposed to the rule of law. Oddly enough, many pose the question but fail to provide an answer. Instead, they assume that, once leaders make the choice to install a particular institutional arrangement, it arises seamlessly. This problem applies not only to “voluntarist” accounts that reduce the problem to one of actor choice but also to arguments that identify impersonal, structural forces behind the choices rulers make; regardless of what drives these choices, most arguments imply that leaders’ decisions to establish the rule of law will necessarily come to fruition once the choice is made.

The only hitch, of course, is that most early-capitalist societies are marked by a proliferation of predatory business actors who thrive from corruption and uncertain property rights and are consequently loath to see the establishment of robust rules to protect private property. These predators must be sidelined in order for any institution-building effort to succeed. How, then, can a sufficiently motivated reformist government effectively marginalize such status-quo interest groups? That is the central question of this study.

The answer is simple: the swift and comprehensive imposition of hard budget constraints. Budget constraints are said to be hard when a firm cannot access external support to artificially boost its income. They are soft when such external support is forthcoming. In the post-communist countries considered here – Estonia, Poland, Slovakia, and Ukraine – soft budget constraints are the common denominator allowing criminal business interests to grow fat off state largesse. Whether in the form of subsidies, cronyist financing, tax breaks, underpriced privatizations, or overpriced state contracts, soft budget constraints, where they are plentiful, channel state wealth into the hands of those with the requisite political connections to obtain them. In doing so, they

⁶ Jean Paul Azam, Robert Bates, and Bruno Biais, "Political Predation and Economic Development," *Economics and Politics* 21, no. 2 (2009); Avinash Dixit, "Predatory States and Failing States: An Agency Perspective," in *CEPS Working Paper No. 131* (Princeton, NJ: Center for Economic Policy Studies, 2006); Thomas Firestone, "Criminal Corporate Raiding in Russia," *International Law* 42, (2008); Vadim Volkov, "Hostile Enterprise Takeovers: Russia's Economy in 1998–2002," *Review of Central and East European Law* 29, no. 4 (2004); Douglass C. North, *Structure and Change in Economic History* (London: W. W. Norton, 1981). James A. Robinson, "When Is a State Predatory?," in *CES Working Paper Series No. 178* (London: Centre for Economic Policy Research (CEPR), 1999); Venelin I. Ganey, *Preying on the State: The Transformation of Bulgaria after 1989* (Ithaca, NY: Cornell, 2006); Jordan Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression," *Post-Soviet Affairs* 28, no. 3 (2012).

lead to a proliferation of predatory actors whose competitive advantage rests not in their entrepreneurial talent but rather their access to the use of force – either the force-wielding agencies of the state or the capacity to use violence directly. Having built their initial fortunes by stealing from the state, it is often a natural and effortless transition to start stealing assets from others through criminal corporate raiding. This is precisely what happened in Poland, Slovakia, and Ukraine.

Estonia's early post-communist governments averted this outcome by moving rapidly to impose hard budget constraints on all business actors. In doing so, they decisively tilted the balance against would-be economic criminals and in favor of entrepreneurs who could actually survive under a regime of hard budgets. Not that Estonian leaders consciously pursued hard budget constraints for this express purpose; they likely followed the policy for entirely different reasons, namely to reduce the budget deficit and create a competitive marketplace. But their motivations were irrelevant; it was the results that mattered. Having gone much further in marginalizing those opposed to the rule of law, Estonia's governments had the leeway they needed to construct a set of robust property rights institutions.

The Estonian achievement in this regard is all the more remarkable given its disadvantageous starting point; a tiny colonial outpost tightly controlled from Moscow, the small Soviet republic – in contrast to Poland and Slovakia – lacked many of the basic institutional trappings of a state administration when it gained independence in 1991. Many of its key institutions had to be created from scratch. And yet successive post-communist governments were able to overcome this severe limitation and build a well-functioning set of property rights institutions. What's more, the lesser prevalence of criminal business actors constantly seeking to corrupt state officials enabled governments to engineer continual improvements over time in the scope and effectiveness of these institutions. This contrasts Estonia from the other three countries, where the trend largely unfolded in the opposite direction.

Why did Estonia end up with a government that went so far in imposing hard budget constraints while none of the other countries did? There is surely an answer to this question, but it is one with which the current study cannot concern itself. At some point, we must choose a certain place to stop in the chain of infinite causal regression;⁷ this dissertation can only do so much. Explaining why some countries got the governments they did while other countries did not is beyond the scope of this investigation. It can merely demonstrate that hard budget constraints mattered. The task of fleshing out the conditions under which governments that harden budget constraints arise must be left to other scholars.

However, even if the ascendancy of these governments was predicated in part on structural forces, agency clearly played an important role in the decisions they made once in power. After all, the first free elections in Poland and Slovakia also saw the rise to power of anti-communist oppositions committed to market reforms. But only Estonia's government went to sufficient lengths to harden budget constraints on economic actors. The reasons why must at least in part be attributed to agency. "Voluntarism" as a social-scientific approach has come under attack in recent decades for presuming that leaders, once in power, can put into place whatever political arrangements they choose. These

⁷ Dan Slater and Erica Simmons, "Informative Regress: Critical Antecedents in Comparative Politics," *Comparative Political Studies* 43, no. 7 (2010).

criticisms are indeed justified – up to a point. Like the voluntarists, this study argues that actors can and do make free choices of great consequence for economic and political progress. Where it departs from the voluntarists is in identifying certain key policies that are necessary in order to effectively counter the structural obstacles that would otherwise consign such efforts to failure.

At the same time, this dissertation equally departs from structural approaches that view actors as the passive followers of whatever institutional rules and norms that history has imposed upon them. As an increasing number of scholars are beginning to point out, certain leaders, by virtue of their beliefs, priorities, commitment, and skills, alter the future institutional trajectories their countries take.⁸

By placing the focus on hard budget constraints, the current investigation offers clear implications for policymakers in early-capitalist countries. To be sure, a study of four countries hardly amounts to adequate scientific proof; further efforts are certainly needed to assess whether its conclusions indeed apply elsewhere. However, the lesson, even if provisional, is clear. To date, most advice to developing countries, including but not limited to those in post-communist Eurasia, has not explicitly prioritized hard budget constraints over other measures. The advice has generally divided along three fronts. The first school emphasizes the need for reform-writ-large, from fiscal and monetary stabilization to deregulation and privatization.⁹ The second has tended to put most of its attention on privatization, analyzing its effects, usefulness, and the different methods for carrying it out.¹⁰ The third argues that leaders must build a full range of market-supporting institutions – capital market rules, financial regulation, a non-corrupt judicial system, etc. – if the policies favored by the first two schools are to have any chance of success.¹¹

⁸ See, for instance, Ken Jowitt, *New World Disorder: The Leninist Extinction* (Berkeley and Los Angeles: University of California, 1992); George W. Breslauer, *Gorbachev and Yeltsin as Leaders* (Cambridge and New York: Cambridge, 2002); George W. Breslauer, *Khrushchev and Brezhnev as Leaders: Building Authority in Soviet Politics* (London: Allen & Unwin, 1982). Robert Rotberg, *Transformative Political Leadership: Making a Difference in the Developing World* (Chicago and London: University of Chicago, 2012); Richard J. Samuels, *Machiavelli's Children: Leaders and Their Legacies in Italy and Japan* (Ithaca and London: Cornell, 2003).

⁹ Anders Åslund, *How Russia Became a Market Economy* (Washington: Brookings, 1995); Leszek Balcerowicz, "Understanding Post-Communist Transitions," *Journal of Democracy* 5, no. 4 (1994); Jeffrey Sachs, "Poland and Eastern Europe: What Is to Be Done?," in *Foreign Economic Liberalization: Transformations in Socialist and Market Economies*, ed. Andras Koves and Paul Marer (Boulder, CO: Westview, 1991); Andrei Shleifer and Robert W. Vishny, *The Grabbing Hand: Government Pathologies and Their Cures* (Cambridge and London: Harvard, 1998); Joel S. Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," *World Politics* 50, no. 2 (1998); Andrei Shleifer and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia* (Cambridge: MIT, 2000).

¹⁰ Eric Hanley, "Cadre Capitalism in Hungary and Poland: Property Accumulation among Communist-Era Elites," *East European Politics & Societies* 14, (1999); Andrew Schwartz, *The Politics of Greed: How Privatization Structured Politics in Central and Eastern Europe* (New York: Rowman & Littlefield, 2006); Konstantin Sonin, "Why the Rich May Favor Poor Protection of Property Rights," *Journal of Comparative Economics* 31, no. 4 (2003); John A. Gould, *The Politics of Privatization: Wealth and Power in Postcommunist Europe* (Boulder, CO and London: Lynne Rienner, 2011); Shleifer and Vishny, 137-50; J. David Brown, John S. Earle, and Scott Gehlbach, "Privatization," in *GMU School of Public Policy Research Paper No. 2012-13* (Fairfax, VA: George Mason University School of Public Policy, 2011).

¹¹ Alice H. Amsden, Jacek Kochanowicz, and Lance Taylor, *The Market Meets Its Match: Restructuring the Economies of Eastern Europe* (Cambridge: Harvard University Press, 1994); Stephen S. Cohen and

If specialists disagree on whether policies or institutions are more important, hard budget constraints involve some of both. But they hardly encompass all of both. What they do offer resource-constrained policymakers – and reformers in early-capitalist countries certainly tend to suffer from severely limited resources – is greater bang for their buck; by weakening corrupt actors committed to the status-quo, hard budget constraints can open the way for the construction of a much broader array of market-supporting institutions. If the countries considered here are any guide, attempts to put property-rights and other institutions into place will likely falter under the weight of opposition from powerful criminal actors unless these actors are swiftly dealt with first.

Herein lies a key difference between this study and other approaches. The current fashion in much of social science is to look at how institutions shape actors. This mode of inquiry is obviously important and useful. But it has led specialists to give what may very well be mistaken advice to policymakers: change the rules, and the actors will behave in ways better suited to a functioning market economy. The evidence uncovered here suggests that attempts to build market-supporting institutions, however well-intentioned, will likely fail if powerful economic criminals have a large presence. In any early-capitalist society there is a group of actors – businesspeople, politicians, regulators, law-enforcement officials, police officers, prosecutors, judges, bankruptcy trustees, and intelligence operatives – who can either allow the rule-of-law to operate or, alternatively, seriously undermine it.

In Poland, Slovakia, and Ukraine, dense networks of such actors conspire with each other to systematically bring state institutions under their thumb in the pursuit of mutual profit. Indeed, as we will see in due course, post-communist Europe is a place where conspiracies really do exist; they are not the imagined concoctions of paranoid recluses. In such an environment, leaders attempting to construct effective market-supporting institutions tend to come up short. Time and again, entrenched networks of conspirators have found ways to design, bend, evade, or otherwise manipulate the rules to serve their own ends.

If the goal is to construct well-functioning state and market institutions, we would be well-served by examining not only how institutions affect actors but also the ways actors shape institutions. This study does both. It first shows how hard budget constraints – which consist of certain key policies and institutions – can help sideline economic predators. This approach is consistent with that of institutionalists. But it then goes one step further, examining how the presence or absence of powerful groups of economic criminals determines the prospects that effective property rights institutions can

Andrew Schwartz, "Deeper into the Tunnel," in *The Tunnel at the End of the Light: Privatization, Business Networks, and Economic Transformation in Russia* (Berkeley: International and Area Studies, University of California, Berkeley, 1998); Firestone, "Criminal Corporate Raiding in Russia."; Massimo Florio, "Economists, Privatization in Russia and the Waning of the Washington Consensus: A Case History," *Review of International Political Economy* 9, no. 2 (2002); Yoshiko M. Herrera, "Russian Economic Reform, 1991-1999," in *Russian Politics: Challenges of Democratization*, ed. Zoltan Barany and Robert G. Moser (London and New York: Cambridge, 2004); Juliet Johnson, *A Fistful of Rubles: The Rise and Fall of the Russian Banking System* (Ithaca, NY: Cornell, 2000); Katharina Pistor, "Supply and Demand for Law in Russia," *East European Constitutional Review* 8, no. 4 (1999); Gérard Roland, *Transition and Economics: Politics, Markets, and Firms* (Cambridge: MIT, 2000); Schwartz; Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W.W. Norton, 2002); *World Development Report 2002: Building Institutions for Markets* (Washington: International Bank for Reconstruction & Development [IBRD] & The World Bank, 2001).

emerge. It is this latter focus – on the role of actors in shaping institutions – that is at once so understudied and so critical to the prospects of early-capitalist societies. This investigation seeks to reveal just how capable status-quo actors are of corrupting and subverting even the most well-designed institutions. If we do not properly understand this point, we may continue offering reform-minded leaders the wrong advice.

The following sections will outline the dependent variables in greater detail, summarize the causal framework, discuss the various literatures that have grappled with these questions, and present the methods by which this study will attempt to answer them.

But first, a note on terminology is in order. The term “soft budget constraints” will be used in this dissertation to denote a range of ways in which economic actors secure external assistance. Frequently, it will serve as a euphemism for resources obtained from external sources that have the effect of artificially boosting the income or reducing the expenditure of the recipient. Consequently, actors will often be described as “receiving” soft budget constraints even though a “constraint” is not generally something a person “receives.” I recognize that the use of this language may initially seem awkward. But it would arguably be even more awkward for the reader to see peppered throughout the text the excessively lengthy and disjointed phrase, “resources obtained from external sources that have the effect of artificially boosting the income or reducing the expenditure of the recipient.” “Soft budget constraints” seems to be an acceptable substitute and will be used instead for brevity’s sake.

The Dependent Variables

This investigation offers an explanation for two separate but related phenomena. The first is criminal corporate raiding. The second is whether or not effective, legal property rights institutions take hold in an early-capitalist environment. The following discussion fleshes out these concepts in greater detail. It also outlines the four dependent variables to which they give rise and that will serve as the main focus of this study.

Criminal corporate raiding is a peculiar form of business takeover that, while probably unfamiliar to observers of the advanced-industrialized economies, is all too familiar to many in the post-communist region. Briefly stated, a criminal corporate raid is *an attempt to take over or destroy a privately-held firm or major shareholding in that firm through the illegal use of force.*¹² This seemingly simple definition contains a number of important nuances that require further elaboration.

To begin with, the subject of this investigation concerns *corporate* raids. As such, the takeover target must be an actual business, not a private residence or parcel of empty real estate. Secondly, to qualify as a raid there need only occur an *attempt* to take over a firm. This does not necessarily presume that the attempt succeeds. Many raid “attempts” can turn into multi-year ordeals to those on the receiving end even if the raid ultimately

¹² The term “criminal corporate raiding” as applied to the post-communist context was likely coined by Firestone in his study of illegal business takeovers in Russia. He defines criminal corporate raiding as “[t]he illegal takeover of businesses.” Firestone, “Criminal Corporate Raiding in Russia,” 1207. Unlike the definition used in the current study, his does not specifically require the use of force to qualify a given takeover as a raid. But he does frequently refer to the use of force, whether through direct or indirect means, in the examples he cites.

fails to attain its final objective. Consequently, such failed attempts constitute a worthy subject of our investigation.

Third, the end-goal of the raid can either be to take control of a company or destroy it altogether. Raiders typically operate with one of three objectives in mind: to secure control of a profitable firm and continue operating it indefinitely, to briefly assume formal control for the purpose of quickly transferring the assets to another entity, or to simply run it out of business. The last objective is typically pursued for political reasons. An example would be an attempt by the government to eliminate a firm that is providing financial support to the opposition. Nevertheless, all three objectives, to the extent that they are acted upon, count as criminal corporate raids.

It must further be noted that the goal need not be to assume formal *ownership* of a company. In many early-capitalist countries, ownership is not nearly as important as control, and establishing control does not necessarily require obtaining a majority shareholding. Even if the raiders fail to gain a majority of the shares in a business, they typically have a variety of means at hand to establish control of its management and assets.

Fourth, the target of the raid must be a privately-held business or private shareholding in that business. Fraudulent privatizations of state-owned firms do not count. An attempt to illegally take over a major private shareholding in a firm that is otherwise under the majority ownership of the state does qualify. The former is an example of a soft budget constraint; in particular, to the extent that the winner of the privatization is able to buy the firm at an artificially low price, it counts as an illegal subsidy from the state. The latter example – the acquisition of a private shareholding through the illegal use of force – is not a soft budget constraint but rather a criminal corporate raid.

Fifth, what makes a corporate raid a *criminal* act is that it involves the violation of some law, even if this violation merely involves the payment of a bribe to a state official who overlooks the whole affair. While a seemingly minor detail, this part of our definition centers the current investigation on the vast criminal world that marks many societies in the early stages of capitalism.

Finally, any criminal corporate raid requires participation by an *agent of force*. This is any actor with the capacity to mobilize the use of organized force and who actually uses this capacity to facilitate the takeover attempt. The agent of force can consist of a team of thugs with machine guns who barge into a shareholders meeting (not an uncommon occurrence in post-communist Europe, as we will see in due course). Alternatively, the agent of force can take the form of a public official in control of the force-wielding organs of the state who uses these agencies to assist in the raid attempt. Again, the force-wielding official need not actively divert the state agencies under her control toward the pursuit of the raid. Sometimes, her only role is to sign off on a decision or even refrain from taking a particular action that might otherwise hamper the takeover attempt. Even then, however, she is using her discretion over whether, when, and how to order the instruments of state force into action and in so doing provides crucial assistance to the raid. Any raid usually requires the help of a state official to either let it happen or make it happen.¹³

¹³ Michael Rochlitz, "Corporate Raiding and the Role of the State in Russia," *Post-Soviet Affairs* 30, no. 2-3 (2013).

However, the state official, to the extent that he or she is involved, must be an actual decision-maker with some discretion over when, how, and in what form the use of force will occur. A mere clerk does not count. What separates the former from the latter is that the decision-maker, as an agent of force, can readily call upon the state's agencies of coercion to support any decision that is made; a clerk cannot. A judge, minister, mayor, governor, prosecutor, police chief, bankruptcy receiver, or any powerful politician all qualify as agents of force. Clerks, such as notaries and registrars, do not count; they reside outside the chain of command that links decision-makers to the state's agencies of coercion.

The initiative for the raid can come from a private business actor who uses his connections with an agent of force to help take over the asset. Alternatively, it can come from the agent of force alone, as when a state official instigates the raid for the purpose of acquiring the company for herself.

While the present investigation has unearthed dozens of criminal corporate raids, most of them fall into a few common categories:¹⁴

Direct force: The first is the use of direct force to take over a business. The methods here can range in sophistication from thick-necked brutes wielding baseball bats to highly-trained, professional private security teams. Direct force is often employed in unison with any of the other types of indirect force described below. In such instances, it is aimed at placing a stamp of finality on a takeover of dubious legality that might otherwise be subject to legal challenge.

Administrative intimidation: In this case the raider enlists the support of one or more of the force-wielding agencies of the state in order to intimidate the target into relinquishing control. A typical example is a prosecutor and/or judge who subject the owner of a firm to criminal prosecution or the threat thereof. Whether the targeted individual is guilty or not is irrelevant; the point is that the person experiences the full brunt of the criminal justice system arbitrarily imposed for the purpose of facilitating the raid. Alternatively, a judge can simply order a freeze on the assets of the targeted company that prevents it from using these assets to obtain financing.

Administrative attacks do not necessitate participation by a prosecutor or judge. There are plenty of other bureaucratic agencies that can suffocate a business to death through the selective imposition of myriad regulations, investigations, and fines. Of course, the owner of the targeted firm can often put a swift end to all of these administrative actions by agreeing to give up the business to the faction behind the attack.

As we will see, administrative attacks by judicial and state regulatory organs acting in concert are the preferred method of raiding in Poland.

Illegal board meetings: In this case, the raider first buys a trivial stake in the target firm and then holds a board meeting in an attempt to replace the current board members and management team. What makes this meeting an illegal raid attempt is either the use of an agent of force such as a judge to authorize the management change (to the extent that a judge's authorization is formally required) and/or efforts to physically prevent the other owners from attending and voting on the proposed changes.¹⁵

¹⁴ For an excellent summary of the different ways raiders use the legal system to takeover businesses in Russia, including many of the tactics described below, see Firestone, "Criminal Corporate Raiding in Russia."

¹⁵ Ibid.

Corporate governance specialists have spilt much ink on the pernicious effects wrought by the abuse of minority shareholder rights at the hands of majority owners. Receiving far less attention is its more menacing opposite: the expropriation of majority owners by minority shareholders. As we will see, such actions are commonplace throughout post-communist Europe.

State-assisted tunneling: In this instance, the raider has already acquired control of a company despite the efforts or knowledge of the other shareholders. He then manages to transfer key assets of the firm to an outside entity owned entirely by him, a practice known as “tunneling.” The raider subsequently enlists the help of a judge to authorize or certify this asset transfer. For instance, the victim might sue the raider for the unlawful asset transfer only to find that the judge is in on the act and decides in the raider’s favor, thereby legitimizing the takeover.

The involvement of a judge in this case, similarly to the above example of an illegal board meeting, is key for our purposes. The judge is an agent of force. Without the involvement of such an agent, the takeover does not count as a raid under our definition. Low-level frauds involving criminal gangs taking control of businesses by submitting forged documents to administrative clerks are common even in advanced-industrialized countries. This study posits a qualitative difference between this phenomenon and what is here defined as a criminal corporate raid. When the criminal can actually bring the coercive power of the state down upon the target by enlisting an agent of force in the takeover, it introduces into the business world an additional and entirely different kind of threat.

Artificial bankruptcy: A final and particularly chilling type of raid is the “artificial bankruptcy.” It begins with the raider purchasing some trivial liability owed by a company and then doing whatever is necessary to prevent the debt from being repaid. Once this happens, the raider can claim that the target firm is in default and subsequently colludes with a bankruptcy judge and receiver to liquidate the company. This often occurs despite the fact that the company is otherwise in perfect financial health. Needless to say, upon liquidation the firm’s assets are sold on the cheap to the clique that orchestrated the raid in the first place.¹⁶

Certain kinds of raid are easy to observe because they are executed by means of highly visible actions carried out in full public view. It is hard to conceal a squad of professional gunmen storming the premises of a business. Unauthorized board meetings often occur with similar blatancy. It is quite common to see two such meetings happening simultaneously that result in the election of two parallel supervisory boards and management teams. One of these competing meetings necessarily has to be unlawful, and when an agent of force is subsequently enlisted to carry out a decision made at one of the meetings, a criminal corporate raid has occurred. Even when multiple meetings of this sort are not occurring, any unauthorized shareholders meeting is sure to elicit loud denunciations from the victimized shareholders with attendant media coverage. Tunneling too can often unfold in full public view. Firms are suddenly emptied of assets and descend into immediate insolvency as a result. In many such cases, the affected shareholders will take their case to the courts and the media.

However, other forms of raiding are far easier to conceal. As such they require a special effort by the analyst to determine whether a raid has actually taken place. The

¹⁶ Ibid.

intimidation of the target by a prosecutor, judge, or other state agency can readily be made to appear as a lawful enforcement action. Likewise, a careful raider can structure an artificial bankruptcy so as to create the impression that the bankruptcy and subsequent sale of the firm's assets are perfectly above-board.

Fortunately, there are a number of ways to determine whether such takeovers constitute criminal corporate raids as opposed to legitimate, lawful actions by the state and/or creditors. The obvious first step is to ask who, if anyone, stood to gain from a given state action against the firm in question. Was anyone vying for control over its assets or seeking to drive the company out of the market? Who's interests were the firm's owners intruding on at the time?

As anyone who watches homicide investigation shows on TV can attest, though, the mere identification of an actor with a motive is not sufficient. Physical evidence is needed, too. However much they may try to hide their actions, raiders do tend to leave telltale fingerprints at the scene of the crime. To begin with, if a particular business actor becomes the subject of state enforcement actions across many different institutional domains at once – not only from the tax authorities but also from the state prosecutor, banking regulator, and anti-monopoly office – this might indicate the presence of somebody acting behind the scenes who is trying to target this actor.

Similarly, when state actions coincide with seemingly spontaneous public demonstrations, lawsuits by aggrieved parties, and the publication of leaflets and articles attacking the takeover target, this can often reflect a coordinated raid attempt. To be sure, sometimes the outpouring of public outrage is perfectly legitimate and may even be prompted by the revelations uncovered by state investigators. However, it is usually easy to determine when such actions have simply been manufactured by raiders. For instance, the lawsuits might have been filed without the knowledge and consent of the parties who are supposedly being represented. The civic organizations mobilizing against the target may have been suddenly created out of thin air by suspicious individuals or may have registered addresses identical to certain entities thought to be behind the raid.

Another indication arises when the authorities launch separate investigations of a business owner's associates for completely unrelated offenses. When the owners of Yukos, the former Russian energy giant, are prosecuted for fraud and tax evasion while the company's head of security is simultaneously investigated for murder, this is not simply a case of a firm that lacks sufficient political connections to avoid such charges. Somebody with an agenda is out to deliberately put pressure on the company's owners.

In another common practice, the authorities charge a business actor with breaking laws that do not even exist. Ukraine's Slavyansky Bank was targeted in this manner. Its owner, Borys Feldman, was prosecuted for failing to pay income tax on a loan he received even though Ukrainian law does not require that any taxes be paid at all in this instance.¹⁷ Someone behind the scenes was clearly targeting this individual.

Suspicious redistributions of assets constitute another indicator of a raid. These can take a variety of forms. To begin with, when the state seizes a business' assets as compensation for some purported violation of the law, the ultimate fate of the assets can be quite telling. Particularly revealing is whether the state subsequently disposes of them in a proper manner or sells them on the cheap to a rival. This is especially useful for

¹⁷ *RFE/RL Newslines*, 18 March 2002; *RFE/RL Poland, Belarus, and Ukraine Report*, 26 February 2002; *ForUm*, 15 March 2002. For *ForUm* articles, go to <http://eng.for-ua.com>.

distinguishing between an artificial bankruptcy and a legitimate one. To whom were the assets sold and to what extent did the prices reflect fair market value?

There is a second way to determine whether or not a bankruptcy was a raid. Many artificial bankruptcies are initiated by a “creditor” (read: raider) who purchased from an actual creditor a nominal, insignificant receivable owed by the targeted firm. Afterwards, the new “creditor” goes to unusual and elaborate lengths to prevent its repayment. For instance, the front company set up to buy the receivable might submit a demand for payment but without providing the creditor’s name or forwarding address. Clearly, the goal here is to be able to claim that the debtor firm is in default. Following this, the raider colludes with a bankruptcy judge and receiver to break up the company and sell its assets on the cheap to the raider himself.

Instances of illicit cooperation between a raider and bankruptcy officials can be quite easy to observe. Frequently, a bankruptcy judge will hand down a decision that is completely at odds with either economic rationality or lawful procedure. For example, she authorizes the collection of a non-existent debt or defers to the authority of tax officials who are obviously pursuing an unlawful tax claim on a supposed debtor. Along with the judge, the bankruptcy receiver too may take actions that are entirely inconsistent with her legal duties of protecting the bankrupt estate and satisfying the claims of creditors in a fair and honest way.

Suspicious asset redistributions can take other forms aside from bankruptcies. For instance, the owner of an especially lucrative business might inexplicably agree to sell it to a particularly influential suitor. The circumstances here suggest that some sort of intimidation was used.

In addition to questionable redistributions of assets, there are still other signs that indicate when a raider is using state institutions to take over another firm. For example, every time a court clears a particular business actor of the criminal charges against her, regulators immediately commence new investigations and file new charges. Alternatively, in the midst of a highly-publicized conflict among rival factions in the government, a prominent businessman connected to one of the factions suddenly gets hit with a series of investigations for wrongdoing. The person’s business is subsequently shut down or sold off with the owners and/or management prosecuted. Another sign is when the target happens to be a commercial or political rival of a well-known and highly politically-connected business actor. In addition, if courts later rule that the actions taken by investigators or prosecutors were illegal, this can suggest a raid occurred, especially if combined with other indicators above. Even if a court does not formally rule the action to have been illegal, illegality can still be inferred under certain circumstances. For instance, when the charges are initially dropped or the alleged perpetrators acquitted but a later trial finds them guilty, this raises suspicions that the judge in the previous case may have been acting to protect the raiders.

Furthermore, the use or threat of direct force against a takeover target qualifies a takeover as a raid. Often times, raiders will use private security teams to help enforce regulatory or court judgments. While this may technically be illegal in some countries, they almost always occur as part of an illegal takeover and will be considered in this study as an indicator of a criminal corporate raid.

Finally, one can often observe the occurrence of direct force, threats, or spontaneous public actions with simultaneous measures by the state against the target.

This is usually not a coincidence; it suggests an attempted raid is in progress, even when only one state agency has undertaken the enforcement measures in question. For example, when the state environmental agency starts investigating a firm, this fact alone is not sufficient to indicate a raid; it may simply be a legitimate enforcement action against the state. But when the investigation happens to coincide with the mass distribution of leaflets accusing the target of damaging the environment, the coincidence of factors may be enough to raise eyebrows.

It must be noted that, even if one or more of the above indicators are present, it does not necessarily constitute incontrovertible evidence that a criminal corporate raid occurred. Nor does it prove that the alleged perpetrator was the actual perpetrator. The previous analogy to a homicide investigation was purely intended for illustrative purposes. It was not meant to imply that a study such as this could ever uncover proof either of the fact of an alleged raid or the identify of the individuals behind it. Any suggestions in this dissertation to the effect that a particular person or entity is a raider or undertook a particular raid ultimately rely on allegations made by others and should be interpreted as such.

Specialists have already devoted much attention to the relationship between post-communist capitalism and criminality. Many observers have looked at the theft of state assets in the form of fraudulent privatizations along with informal siphoning from state agencies and firms.¹⁸ They have also examined the phenomenon of “state capture,” which involves illicit payments by firms to corruptly influence the formation of policies, rules, and regulations.¹⁹ Other scholars have analyzed protection rackets and criminal

¹⁸ Bernard S. Black, Reinier Kraakman, and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?," *Stanford Law Review* 52, (2000); Clifford G. Gaddy and Barry W. Ickes, "Stability and Disorder: An Evolutionary Analysis of Russia's Virtual Economy," in *Russia in the New Century: Stability or Disorder?*, ed. Victoria E. Bonnell and George E. Breslauer (Boulder, CO: Westview, 2001); Ganev; Venelin I. Ganev, "The Separation of Party and State as a Logistical Problem: A Glance at the Causes of State Weakness in Postcommunism," *East European Politics and Societies* 15, no. 2 (2001); Venelin I. Ganev, "The Dorian Gray Effect: Winners as State Breakers in Postcommunism," *Communist and Post-Communist Studies* 34, no. 1 (2001); Gould; Anna Grzymała-Busse, *Rebuilding Leviathan: Party Competition and State Exploitation in Post-Communist Democracies* (New York: Cambridge, 2007); Karla and Joseph E. Stiglitz Hoff, "After the Big Bang? Obstacles to the Emergence of the Rule of Law in Post-Communist Societies," *American Economic Review* 94, no. 3 (2004); Preston Sterner Keat, *Playing Favorites: Government Aid and Industrial Restructuring in Post-Socialist Poland*. (UCLA: Unpublished PhD Dissertation, 2002); Conor O'Dwyer, *Runaway State-Building: Patronage Politics and Democratic Development* (Baltimore: Johns Hopkins, 2006); Schwartz; Grażyna Skąpska, "The Rule of Law, Economic Transformation and Corruption after the Fall of the Berlin Wall," *Hague Journal of the Rule of Law* 1, no. 2 (2009); Alexander Kupatadze, *Organized Crime, Political Transitions, and State Formation in Post-Soviet Eurasia* (Basingstoke, UK and New York: Palgrave MacMillan, 2012); Steven L. Solnick, *Stealing the State: Control and Collapse in Soviet Institutions* (Cambridge, MA: Harvard, 1998); J. Staniszkis, "'Political Capitalism' in Poland," *East European Politics & Societies* 5, no. 1 (1990); Janine R. Wedel, "Clans, Cliques and Captured States: Rethinking Transition in Central and Eastern Europe and the Former Soviet Union," *Journal of International Development* 14, no. 4 (2001). Atanasov et al. (2008) look at tunneling per se, whether from state- or private-owned firms. Vladimir A. Atanasov, Bernard S. Black, and Conrad S. Ciccotello, "Unbundling and Measuring Tunneling," in *Law and Econ Research Paper No. 117* (Austin, TX: University of Texas Law School, 2008).

¹⁹ Steven Fries, Tatiana Lysenko, and Saso Polanec, *The 2002 Business Environment and Enterprise Performance Survey: Results from a Survey of 6100 Firms* (London: European Bank for Reconstruction & Development (EBRD), 2003); C. Gray, J. Hellman, and R. Ryterman, *Anticorruption in Transition 2: Corruption in Enterprise-State Interactions in Europe and Central Asia 1999 – 2002* (Washington: The

organizations involved in illegal economic spheres²⁰ while still others have focused on rent-seeking more generally.²¹ Some have sought to explain differences in the ability of market institutions to fulfill their formal purposes (protecting minority shareholders, allocating capital to enterprises, etc.).²²

World Bank, 2004); J. Hellman, G. Jones, and D. Kaufmann, "Seize the State, Seize the Day: State Capture, Influence, and Corruption in Transition," in *Policy Research Working Paper No. 2444* (Washington: The World Bank, 2000); J. Hellman et al., "Measuring Governance, Corruption, and State Capture: How Firms and Bureaucrats Shape the Business Environment in Transition Economies," in *Working Paper No. 2312* (Washington: The World Bank, 2000); J. Hellman and M. Schankerman, "Intervention, Corruption and Capture: The Nexus between Enterprises and the State," in *Working Paper No. 58* (London: EBRD, 2000).

²⁰ Kupatadze; Virginie Coulloudon, "Moscow City Management: Russian Capitalism?," in *Business and the State in Contemporary Russia*, ed. Peter Rutland (Boulder, CO: Westview, 2001); Timothy Frye, "Private Protection in Russia and Poland," *American Journal of Political Science* 46, no. 3 (2002); Timothy Frye and Ekaterina Zhuravskaya, "Rackets, Regulation, and the Rule of Law," *Journal of Law, Economics, and Organization* 16, no. 2 (2000); Stephen Handelman, *Comrade Criminal: Russia's New Mafiya* (New Haven, CT: Yale, 1995); Jovo Nikolov, "Organized Crime in Bulgaria," *East European Constitutional Review* 6, no. 4 (1997); Vadim Radaev, "The Spread of Violence in Russian Business in the Late 1990s," in *PONARS Policy Memo No. 66* (1999); Frederico Varese, *The Russian Mafia* (Oxford & New York: Oxford, 2001); Vadim Volkov, *Violent Entrepreneurs: The Use of Force in the Making of Russian Capitalism* (Ithaca, NY: Cornell, 2002); Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression."

²¹ Yevgenia Albats, *Bureaucrats and the Russian Transition: The Politics of Accommodation, 1991-2003* (Harvard: Unpublished PhD Dissertation, 2004); Andrew Barnes, "Comparative Theft: Context and Choice in the Hungarian, Czech, and Russian Transformations, 1989-2000," *East European Politics and Societies* 17, no. 3 (2003); Lynnley Browning, "Neither State nor Market: Cozy Reciprocity in Russian Capitalism," (Cambridge, MA: Belfer Center for Science and International Affairs, 1998); Keith Darden, "The Integrity of Corrupt States: Graft as an Informal State Institution," *Politics & Society* 36, no. 1 (2008); Keith Darden, "Blackmail as a Tool of State Domination: Ukraine under Kuchma," *East European Constitutional Review* 10, no. 2-3 (2001); M. Steven Fish, "The Roots and Remedies of Russia's Racket Economy," in *The Tunnel at the End of the Light: Privatization, Business Networks, and Economic Transformation in Russia*, ed. Stephen S. Cohen, Andrew Schwartz, and John Zysman (Berkeley: International and Area Studies, 1998); Timothy Frye, "Capture or Exchange? Business Lobbying in Russia," *Europe-Asia Studies* 54, no. 7 (2002); Timothy Frye and Andrei Shleifer, "The Invisible Hand and the Grabbing Hand," *American Economic Review* 87, no. 2 (1997); Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions."; Johnson; S. Johnson, J. McMillan, and C. Woodruff, "Property Rights and Finance," *American Economic Review* 95, no. 5 (2002); M McFaul, "Russia's 'Privatized' State as an Impediment to Democratic Consolidation, Part I," *Security Dialogue* 29, no. 2 (1998); Vadim Radaev, "Corruption and Administrative Barriers for Russian Business," in *Political Corruption in Transition: A Skeptic's Handbook*, ed. Stephen Kotkin and Andras Sajó (New York: Central European University Press, 2002); Peter Rutland, "Business Lobbies in Contemporary Russia," *The International Spectator* XXXII, no. 1 (1997); Peter Rutland, "Introduction: Business and the State in Russia," in *Business and the State in Contemporary Russia*, ed. Peter Rutland (Boulder, CO: Westview, 2001); Evgeny Yakovlev Slinko and Ekaterina Zhuravskaya, "Effects of State Capture: Evidence from Russia's Regions," in *Building a Trustworthy State in Post-Socialist Transition*, ed. Janos Kornai and Susan Rose-Ackerman (New York: Palgrave MacMillan, 2004); Yan Sun, "Reform, State, and Corruption: Is Corruption Less Destructive in China Than in Russia?," *Comparative Politics* 32, no. 1 (1999); Alexandra Vacroux, "Regulation and Corruption in Transition: The Case of the Russian Pharmaceuticals Markets," in *Building a Trustworthy State in Post-Socialist Transition*, ed. Janos Kornai and Susan Rose-Ackerman (New York: Palgrave MacMillan, 2004); Lucan Way, *Bureaucracy by Default: Preserving a Public Dimension of the State in Post-Soviet Ukraine* (Unpublished PhD Dissertation: University of California, Berkeley, 2001).

²² Mark A. Dutz and Maria Vagliasindi, "Competition Policy Implementation in Transition Economies: An Empirical Assessment," in *Working Paper No. 47* (London: EBRD, 1999); Gerald Easter, "The Russian Tax Police," *Post-Soviet Affairs* 18, no. 4 (2002); EBRD, *Corporate Governance Assessment Project*

Despite this voluminous literature, few have examined criminal corporate raiding specifically. To the extent that it has received attention, this has mostly come in the form of single-country case studies (particularly of Russia) rather than cross-national analyses.²³ This study is aimed not only at garnering more attention among specialists to this enormous problem but also at systematically exploring its causes using the only tool we have to do so: the comparative method. I am not the first to examine the determinants of raiding in comparative perspective; Michael Rochlitz analyzed the sources of inter-regional variations within Russia.²⁴ However, few if any specialists have looked at the question cross-nationally.

Being that criminal corporate raids are almost entirely perpetrated by members of the business and political elite, it is this elite stratum that will serve as the main focus of this investigation. I distinguish between two segments of this group, in particular. The first is made up of the very richest private businesspeople, referred to here as the *plutocratic elite*. The second consists of less wealthy elites along with state officials who perpetrate raids on their own behalf. I will label to this second stratum as the *non-plutocratic elite*.

To be sure, any attempt to impose hard and fast criteria to who belongs to the plutocratic versus the non-plutocratic elite will necessarily prove somewhat arbitrary. This investigation will limit its definition of the plutocratic elite to those individuals who have appeared on annual published lists of the top-20 wealthiest private businesspeople from 2007 to 2012. Any business actor residing outside of this top stratum, including state officials who are in business for themselves, will be defined as members of the non-plutocratic elite.

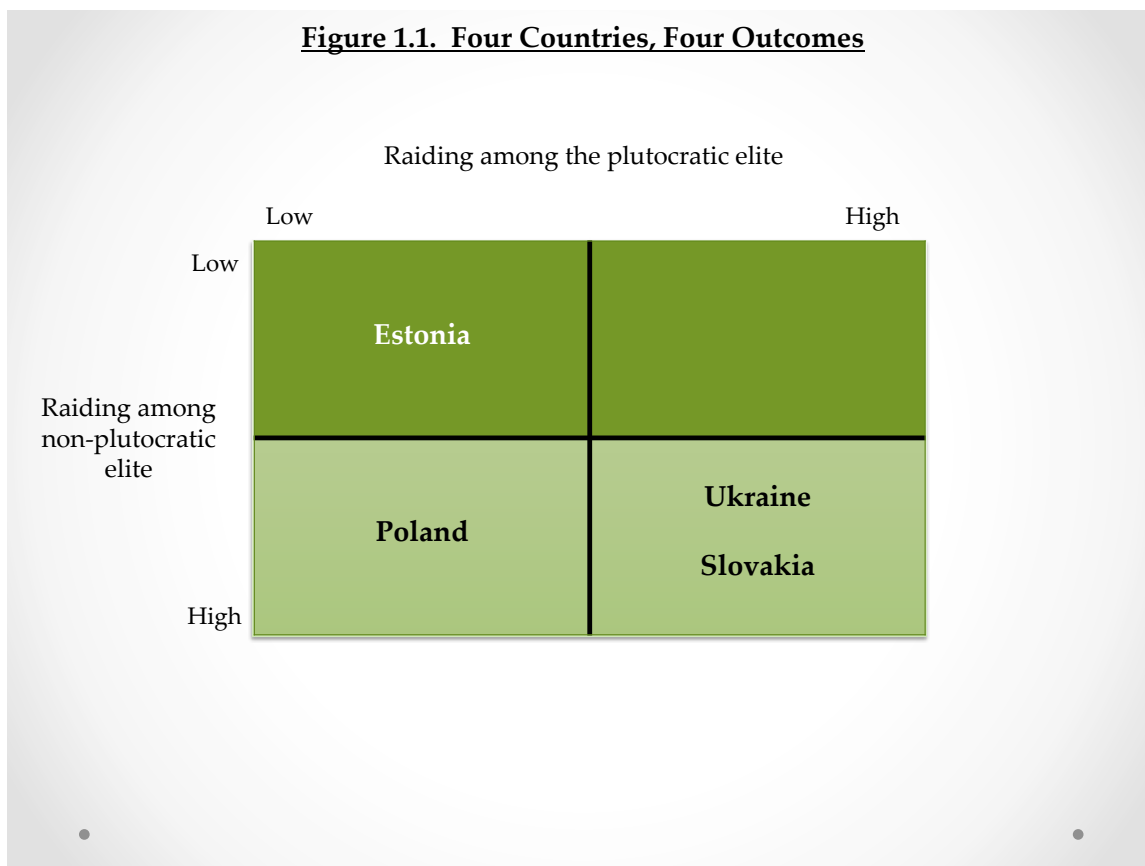
Examining the incidence of raiding among the plutocratic and non-plutocratic elites, as defined here, produces a four-way box in which we can place each of the four countries (Figure 1.1). Ukraine and Slovakia exhibit widespread raiding among both the plutocratic and non-plutocratic elites. Poland is marked by little raiding among the plutocratic stratum but pervasive raiding among the non-plutocratic elite. Estonia displays little raiding among both groups.

(London: EBRD, 2003); Timothy Frye, *Brokers and Bureaucrats: Building Market Institutions in Russia* (Ann Arbor, MI: University of Michigan, 2000); E. Glaeser, S. Johnson, and A. Shleifer, "Coase Versus the Coasians," *The Quarterly Journal of Economics* 116, no. 3 (2001); Kathryn Hendley, "Legal Development in Post-Soviet Russia," *Post-Soviet Affairs* 13, no. 3 (1997); Kathryn Hendley, Peter Murrell, and Randi Ryterman, "Law, Relationships, and Private Enforcement: Transactional Strategies of Russian Enterprises," *Europe-Asia Studies* 52, no. 4 (2000); David Woodruff, *Money Unmade: Barter and the Fate of Russian Capitalism* (Ithaca, NY: Cornell, 1999); David Woodruff, "Rules for Followers: Institutional Theory and the New Politics of Economic Backwardness in Russia," *Politics & Society* 28, no. 4 (2000); David Woodruff, "Property Rights in Context: Privatization's Legacy for Corporate Legality in Poland and Russia," *Studies in Comparative International Development* 38, no. 4 (2004); Natalya Yacheistova, *Competition Policy in Countries in Transition: Legal Basis and Practical Experience* (New York and Geneva: UNCTAD, 2000).

²³ See, for example, Firestone, "Criminal Corporate Raiding in Russia."; Volkov, "Hostile Enterprise Takeovers: Russia's Economy in 1998–2002."; William Thompson, "Putting Yukos in Perspective," *Post-Soviet Affairs* 21, no. 2 (2005); Rochlitz, "Corporate Raiding and the Role of the State in Russia."; Rostislav Kapeliushnikov et al., "Threats to Security of Property Rights in a Transition Economy: An Empirical Perspective," *Journal of Comparative Economics* 41, no. 1 (2013).

²⁴ Rochlitz, "Corporate Raiding and the Role of the State in Russia."

Figure 1.1. Four Countries, Four Outcomes



Note that, while the countries number four, the actual cases number eight: (1) little raiding among the plutocratic elite in Estonia, (2) little raiding among the non-plutocratic elite in Estonia, (3) little raiding among the plutocratic elite in Poland, (4) extensive raiding among the non-plutocratic elite in Poland, (5) extensive raiding among the plutocratic elite in Slovakia, (6) extensive raiding among the non-plutocratic elite in Slovakia, (7) extensive raiding among the plutocratic elite in Ukraine, and (8) extensive raiding among the non-plutocratic elite in Ukraine. Any valid explanation of criminal corporate raiding in the four countries must account for all eight of these variant outcomes.

The third dependent variable is whether or not robust and authoritative property rights institutions emerged. Scholars, particularly those studying early-modern Europe, have pointed to a broad range of institutions that developed over time and enabled the protection of legal property rights. Among these were merchant courts;²⁵ merchant guilds;²⁶ bills of exchange; fairs; banks, insurance companies, and specialized financial houses; and sophisticated auditing and accounting methods.²⁷

²⁵ Paul R. Milgrom, Douglass C. North, and Barry R. Weingast, "The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs," *Economics and Politics* 2, no. 1 (1990).

²⁶ Avner Greif, Paul Milgrom, and Barry R. Weingast, "Commitment and Enforcement: The Case of the Merchant Guild," *Journal of Political Economy* 102, no. 4 (1994).

²⁷ Douglass C. North, "Institutions," *Journal of Economic Perspectives* 5, no. 1.

Of these, two stand out as the most critical: a state and judicial system that collectively possess a monopoly over the use of force and effectively impose legal constraints on the arbitrary discretion of public officials. For these are the fundamental institutions on which the effectiveness and enforceability of all the others depend.²⁸ In other words, if firms are to be protected against raiding and extortion, society's agents of force must reside exclusively in the employ of the state and remain subject to binding formal limits on their actions.

The four countries in this study can all be characterized as having states that possess a reasonably effective monopoly over the use of force.²⁹ The main difference, if any, will rest in the latter dimension: the ability of the state to successfully impose binding formal limits on its officials.

This second dimension of institutional robustness – the state's ability to impose binding limits on its officials – can in turn be broken down into three elements. The first is the bureaucratic integrity of state institutions. Bureaucratic integrity refers to the degree to which officials are rewarded for demonstrating competence in fulfilling their formal duties (as opposed to personal loyalty) along with the extent to which hiring and promotion is based on merit versus personal connections. The second is the strength of institutional constraints on corruption. Given these institutional constraints, a third dimension is the degree to which an especially well-connected individual, whether from inside or outside the state apparatus, can corruptly influence the particular person he needs in order to achieve some illicit end. The logic of this third line of inquiry is that even where state institutions can deter the average businessperson from trying to bribe a state official, those who are especially rich and well-connected might still be able to get away with it. And when it comes to raiding, in particular, all that is needed is for such an individual to influence a few key public servants who are necessary to carrying out raids. For purposes of the current investigation, then, an effective state and judicial system not only commands a monopoly over the use of force. It is also characterized by a high level of bureaucratic integrity and strong constraints on corruption, even among society's most powerful and influential individuals.³⁰

Note that we are talking here about the *capacity of the state* to impose such limits, not the *willingness of leaders* to do so. The choices of leaders do constitute an independent variable in this analysis, but the question of institutional capacity under consideration here is a dependent variable, not an independent one. To get a state with sufficient institutional strength, this study argues, the right actors must first emerge and make the right decisions while the wrong types of actors must be sidelined. If state institutions can develop over a sufficient amount of time without being constantly sabotaged by economic criminals, they might develop the kind of independent, self-

²⁸ Ibid.; Max Weber, *Economy and Society: An Outline of Interpretive Sociology* (Berkeley: University of California, 1978 [1922]), 941-1110.

²⁹ Among its Governance Indicators, the World Bank rates countries on political stability and the absence of violence. Each country is scored on a five-point scale ranging from -2.5 (low stability/high violence) to +2.5 (high stability/low violence). Taking into account their average scores from 1996 to 2011, Estonia, Poland, and Slovakia fall within a very tight range (with averages of 0.66, 0.63, and 0.87, respectively). Ukraine comes up slightly worse at -0.23. "Worldwide Governance Indicators," (Washington: The World Bank, www.govindicators.org).

³⁰ My conceptualization of a bureaucratic (as opposed to patrimonial) state is derived from that of Weber, 941-1110.

enforcing capacity that is the hallmark of an effective state. It is this latter form of *capacity* to which the dependent variable refers.

If the two raiding variables produce eight separate cases, whether or not robust property rights institutions emerged gives rise to four: (1) weak property rights institutions in Ukraine, (2) weak property rights institutions in Poland, (3) similarly feeble institutions in Slovakia, and (4) the establishment of effective property rights institutions in Estonia. The widespread incidence of raiding among either or both elite groups in the former three countries means property rights institutions there are, by definition, not doing their job. Estonia is the only country out of the four where strong and robust property rights institutions have actually taken root.

Many readers have likely noted that the findings of this study – especially for Poland and Slovakia – contradict the conventional wisdom among scholars, specialists, and other observers of the post-communist region. Most recognize Ukraine to be a bastion of crony capitalism, criminality, and weakly-enforced property rights. There is a similar consensus that Estonia's institutions have become an exemplar of Scandinavian honesty and efficiency. But the scholarly literature³¹ as well as the Western media³² have similarly cast Poland and Slovakia alongside Estonia as among the region's leaders in the development of modern market economies. This study will present evidence to the contrary. In particular, it will document widespread and systematic abuses of property rights that have occurred in these two countries – and abuses of the most destructive kind imaginable.

While some of these instances could be characterized as high-profile, most were not. In fact, many of my respondents were completely unaware of the majority of the raids I ultimately found. Hendley convincingly argues that the commonly-held perception that the rule of law does not work in Russia is unduly influenced by a handful of highly-publicized examples. The reality, she asserts, is that the more mundane disputes indeed tend to be successfully resolved through prevailing legal institutions.³³ In the countries examined here, however, raiding is not at all confined to the most visible cases. It runs throughout the business world, affecting actors both large and small. Where raiding is indeed frequent, the researcher is confronted with a seemingly inexhaustible supply of examples. The more one looks, the more one will find.

Aside from variations in the degree of raiding and the strength of property rights institutions, an additional question this study addresses is why certain business actors

³¹ See, for example, Maluda Vachudova, *Europe Undivided: Democracy, Leverage and Integration after Communism* (Oxford: Oxford, 2005). Most of the accolades have fallen on Poland rather than Slovakia. See Gould, 103-04; Timothy Frye, *Building States and Markets after Communism: The Perils of Polarized Democracy* (New York: Cambridge, 2010); R. Schoenman, "Captains or Pirates? State-Business Relations in Post-Socialist Poland," *East European Politics and Societies* 19, no. 1 (2005); Grzymała-Busse, 81-87; Woodruff, "Property Rights in Context: Privatization's Legacy for Corporate Legality in Poland and Russia."; Shleifer and Vishny, Ch. 11; Andrew Harrison Schwartz and Jordan Gans-Morse, "Plutocracy Escaped, Plutocracy Avoided, Plutocracy Embedded," in *The Politics of Greed: How Privatization Structured Politics in Central and Eastern Europe*, ed. Andrew Schwartz (New York: Rowman & Littlefield, 2006); Stiglitz, chapter 7; Gerald M. Easter, *Capital, Coercion, and Postcommunist States* (Ithaca, NY: Cornell, 2012); IBRD & The World Bank, 11.

³² See, for instance, Alexei Barrionuevo, "Vigorous Slovakia Emerges," *The Wall Street Journal Europe*, 12 January 2005.

³³ Kathryn Hendley, "Assessing the Rule of Law in Russia," *Cardozo Journal of International and Comparative Law* 14, no. 2 (2006).

engage in raiding while others do not. While the three modes of variation described above are cross-national in nature, this fourth type involves differences across business actors. I am using the term “business actor” broadly in this study. It refers not only to private businesspeople but also politicians and state officials who control business assets themselves.

In sum, the current investigation focuses on four dependent variables: the frequency of raiding among the plutocratic elite, the frequency of raiding among the non-plutocratic elite, whether or not effective property rights institutions were established, and the likelihood that a given business actor would engage in raiding.

The Three Stages of Early Capitalism

The causal framework this study advances to account for these different outcomes hinges critically on the passage of time. The various explanatory variables can be distinguished according to the particular stages at which they operate. In particular, one can identify three distinct stages that any society undergoes during the early phase of capitalism (Figure 1.2).

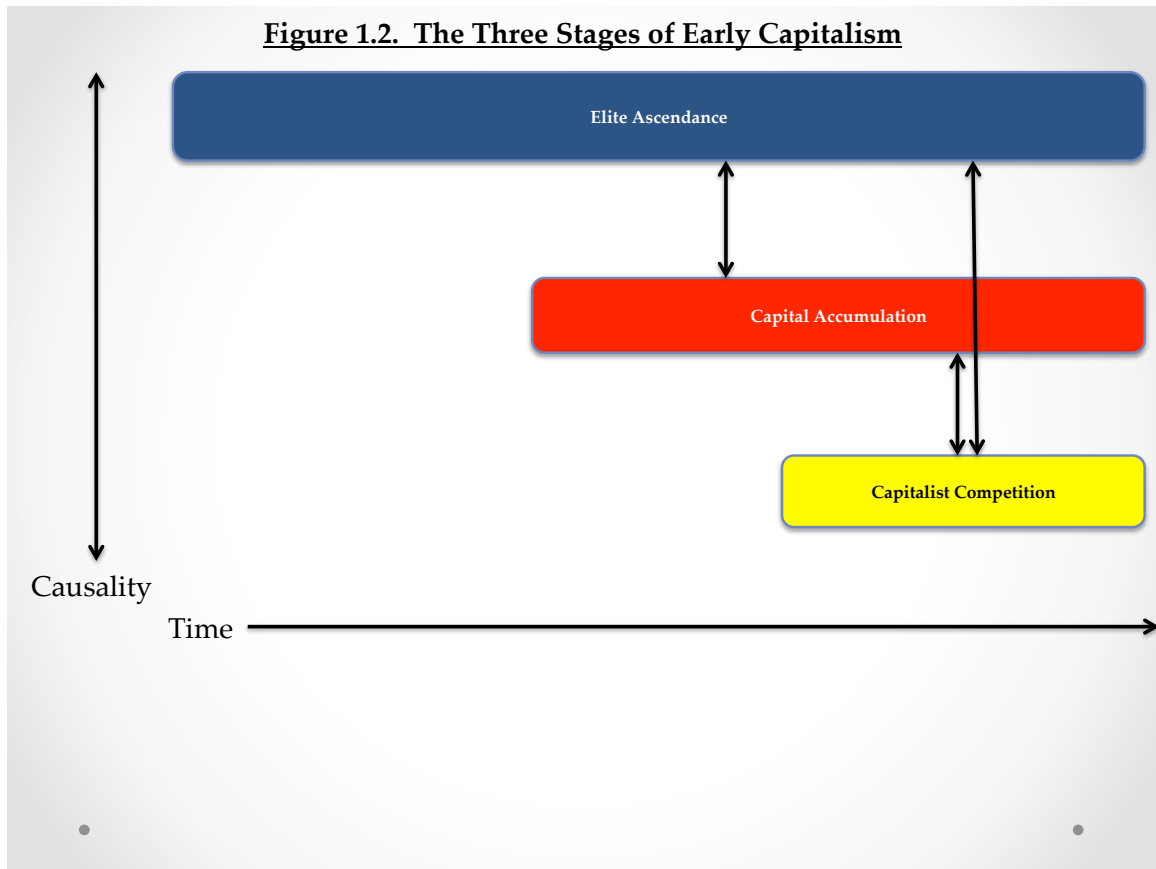
The first stage is that of *elite ascendance*. This is the process by which one or more *rulers* ascend to political prominence in the kind of large and variegated society that can eventually host a capitalist economy. In the post-communist context, this stage began during the last years of communist rule. It continued to proceed as one or more individuals and/or political parties ascended to power under the post-communist regime. In general the elite ascendance stage does not have to involve the replacement of one set of rulers by another. What matters is that, at the onset of the next stage, some class of political rulers will necessarily be in charge. Their beliefs, agendas, and institutions will carry major consequences for what happens in the ensuing stages.

The second stage is marked by *capital accumulation*. This is the process by which the first capitalists begin accumulating economic resources. The specific source of this capital varies across societies and historical periods. However, a key distinction hinges on the degree to which capital originates from indigenous production or state assets. Early modern Europe typifies the first alternative while post-communist Europe exemplifies the latter.³⁴

The third stage is *capitalist competition*. Once the first capitalists have begun accumulating capital, they will start competing with one another. The particular form this competition takes varies across societies. The manner of variation most relevant to the current study is the degree to which capitalist competition involves the use of force for private ends. Indeed, it is this final stage of early capitalism at which the dependent variables of this study – the degree of raiding, who engages in raiding, and whether or not robust legal property rights institutions emerge – are situated. The explanatory variables, for their part, are located at the two prior stages, those of elite ascendance and capital accumulation.

It is useful to distinguish among these three stages for several reasons. First, as the preceding discussion suggests, they offer a way of locating the independent,

³⁴ Venelin I. Ganev, "Post-Communism as an Episode of State Building: A Reversed Tillyan Perspective," *Communist and Post-Communist Studies* 38, no. 4 (2005).



intervening, and dependent variables at their appropriate places in time. What will become quite evident in due course is the way in which the different variables in the analytical framework enter into the analysis at different points in time. The three-stage classification allows one to systematically identify the role each variables plays as the early-capitalist era unfolds.

Second, the particular character of one stage can significantly affect that of the next (Figure 1.2). For instance, the kind of rulers that come to power during the elite-ascendancy stage will greatly impact the form that capital accumulation will subsequently assume. The attributes of these elites and the manner in which they ascended to and wield power (stage one) will carry important implications for the nature of the capital accumulation process (stage two) along with that of capitalist competition (stage three).

Each prior stage necessarily precedes each subsequent stage. This is not a hypothesis but is rather true by definition. Before the first capitalists begin accumulating capital, they must already inhabit a political unit governed by one or more rulers. Likewise, a state of competition among economic actors (stage three) presumes the prior existence of the actors themselves (stage two). Therefore, just as the elite ascendancy stage by definition precedes the capital accumulation stage, the latter necessarily precedes the capitalist competition stage.

This is not to say that when a prior stage gives way to the next that it suddenly ceases to unfold. In fact, this should rarely be the case. In most societies, the struggle for ascendancy among competing rulers persists even after capital accumulation has initially gotten under way. Similarly, economic actors continue accumulating capital well after they have begun to compete with one another. As such, the three stages are best seen not

as static phases but rather dynamic processes that continue to evolve alongside subsequent stages.

Furthermore, once each subsequent stage begins, it can have feedback effects on the character of the stage that preceded it (Figure 1.2). As we will see, the critical decision that early post-communist governments made was whether to impose hard budget constraints on economic actors. This is something that happened (or did not happen) at the elite ascendance stage since it relates to the rise to power of the political elite and the actions they undertook. Where this new elite did not adopt sufficient measures to implement hard budget constraints, the result was the emergence of a new class of economic actors who made their first fortunes thanks to the siphoning of state resources (an event that took place during the capital accumulation stage). These new businesspeople subsequently managed to suborn even the most reformist governments into corrupt relationships with profound consequences. In this way, events at the elite ascendance stage drove events during the capital accumulation phase which in turn shaped the character of elite ascendance as it continued to unfold throughout the post-communist period. However, as stated earlier, the *onset* of a later stage by definition cannot precede that of an earlier one.

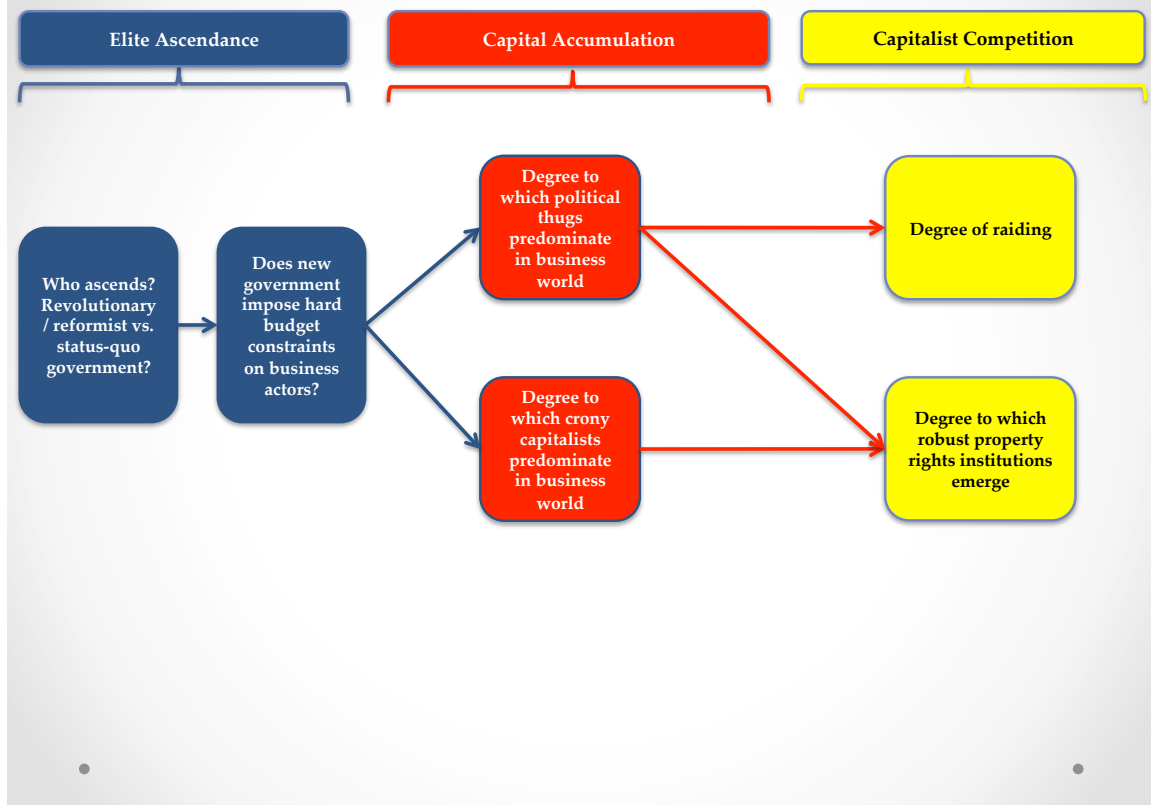
Another advantage of separating the early capitalist period into distinct stages is that it avoids the problem of endogeneity. How are we to know that one particular variable causes another rather than being caused by it? As noted in the preceding paragraph, a variable at a later stage can indeed exert feedback effects on one that initiates during an earlier stage. But to the extent that the *initiation* of one variable occurs during a later stage in analytical time, it cannot act as a cause for another variable that appeared beforehand.

Finally, as the above discussion suggests, the three-part categorization is parsimonious. This is a particularly useful feature since it allows the framework to be applied to *any instance* of early capitalism from late-seventeenth-century England to late-twentieth-century China. As such, the character and relationships between the different stages in one context can be systematically compared with those in a different context. This can greatly aid the task of hypothesis-testing and theory-building on all manner of phenomena relevant to the study of comparative political economy. Let us now embark on this task for the particular study at hand.

A General Causal Framework

This section will introduce the basic causal framework of the dissertation (Figure 1.3). The framework outlined below is presented in a more simplified and general fashion than the version that will appear in Chapter Three. There are two reasons for this. First, the full analytical structure of the argument is quite complex. The reader may thus find it useful to consider the argument in parts from its simplest to most elaborate form. Second, the objective here is to provide an analytical framework that can apply not only to the post-communist region itself but to other instances of early capitalism as well. The version presented in this chapter is accordingly parsimonious, potentially capable of explaining variations on the dependent variables in any historical context. Chapter Three will render the variables in a form more specific to the post-communist region. In each

Figure 1.3. The General Causal Framework



of the two versions, the different variables will be distinguished according the particular stage of early capitalism at which they enter into the analysis.

It is important to note that the parsimonious framework below is merely a hypothesis derived from the evidence uncovered in Estonia, Poland, Slovakia, and Ukraine. It has not been tested against evidence from any other parts of the world – or, indeed, any other countries in the post-communist region. This would require in-depth field investigations in additional countries on multiple continents, something that is beyond the scope of this study.

Stage One: Elite Ascendancy

Scholars have generally distinguished between two modes by which major developmental change can occur. *Reformist* change, to the extent that it targets multiple problems and issues, addresses them separately and incrementally. Reformists themselves typically pursue change through the existing political system. They also tend to rely on a relatively broad base of support.³⁵ Reformist change is consistent with what Thelen refers to as institutional “layering;” it involves the “partial renegotiation” of some elements of an

³⁵ Ken Jowitt, *Revolutionary Breakthroughs and National Development: The Case of Romania, 1944-1965* (Berkeley: University of California, 1971), 8-10.

institution while leaving other elements unchanged. New arrangements are thereby “grafted” on top of existing structures rather than replacing those structures completely.³⁶

If reformist change approaches issues separately and incrementally, *revolutionary* change treats problems in terms of their interdependent and urgent nature.

Revolutionaries regard society’s predicament as systemic in essence. Consequently, they resist any solutions that involve working within the existing system and rather seek to replace the system itself, as Jowitt explains.³⁷ This concept of revolution is comparable to the “punctuated equilibrium” model of institutional development in which long periods of stasis are punctuated by sudden and far-reaching upheavals.³⁸ However, the concept of revolutionary change presented here departs from that of Jowitt insofar as it does not necessarily involve violence. The changes that occurred in Eastern Europe (in this study, Estonia) were just as revolutionary as any prior instance of revolution. The Estonian revolutionaries that ascended in 1992 approached the problems of their society as interdependent, systemic, and urgent but without resorting to violence.

The general causal framework deems both reformists and revolutionaries as the key actors capable of engineering transformations in prevailing property rights structures in an early-capitalist society. Either, under the right conditions, can take an early-capitalist society off a trajectory of widespread raiding and other abuses and put it onto one in which effective and efficient property rights institutions can emerge.

Reformists and revolutionaries do not mix well together. Almost always, it will be either reformists or revolutionaries, not both, who ultimately bring about the decisive shift. In most of the world, the transformation toward efficient property rights institutions tended to occur through reformist means.³⁹ New governments occasionally came to power and implemented piece-meal changes in the economic realm. But they did so while leaving prevailing political and social structures largely intact.

In the post-communist world, the breakthrough to a new and efficient property rights arrangement assumed a uniquely revolutionary character. This was due to the nature of the communist system itself, defined as it was by a set of interlinked political, economic, and social institutions regarded by elites and society as distinctly “communist.” Naturally, then, many new governments that took power in the early transition years viewed the problems besetting this system as the result of the system itself. The whole structure, in its political, economic, and social forms, would have to be replaced in one fell-swoop. Where fundamental change did occur, revolution and not reform tended to rule the day. In general, however, the ascendance of either type of political leadership creates the potential for this process to take place. The type of political elite that ascends to power – whether revolutionary, reformist, or status-quo – is a dichotomous variable, not a continuous one.

³⁶ Kathleen Thelen, "How Institutions Evolve: Insights from Comparative Historical Analysis," in *Comparative Historical Analysis in the Social Sciences*, ed. James Mahoney and Dietrich Rueschemeyer (Cambridge and New York: Cambridge, 2003).

³⁷ Jowitt, *Revolutionary Breakthroughs and National Development: The Case of Romania, 1944-1965*, 8-10.

³⁸ Stephen D. Krasner, "Sovereignty: An Institutional Perspective," *Comparative Political Studies* 21 21, no. 1 (1988).

³⁹ France constitutes the major exception. See Theda Skocpol, *States and Social Revolutions: A Comparative Analysis of France, Russia and China* (Cambridge and New York: Cambridge, 1979).

Reformists and revolutionaries seeking to put legal property rights institutions into place face a powerful obstacle in the form of entrenched interest groups bent on preserving existing property rights arrangements. These status-quo interests take the form of economic actors and their political representatives whose very livelihood depends on opportunities for abusing the property rights of others.⁴⁰ To the extent that such actors maintain control of the state, raiding will remain commonplace and the development of robust property rights institutions will prove impossible.

Even if reformists or revolutionaries do manage to seize the reins of power, they will still encounter intense opposition from defenders of the status-quo. These actors will work to oust the new government from power or alternatively bribe it to keep any changes minimal. Any such government that seeks to consolidate and preserve its hold on power will find it tempting to give into these status-quo interests. Maintaining power can be difficult when wealthy and powerful actors are heaping financial largesse upon one's political opponents. It becomes far easier when these resources are marshaled in one's own favor. As a result, the political logics favoring stability over change will often prove impossible for many (if not most) new governments, whether reformist or revolutionary, to resist.

At the time the new government comes to power, a large and powerful class of predatory economic actors likely exists already. This was true even in the post-communist countries, where no independent economic actors of any type had a longstanding presence. In most countries, certain economic interests had already established significant fortunes during the early post-communist years and in many cases even before communism collapsed. This was thanks mostly to their access to coercive resources. These individuals accordingly represented supporters of the status quo and would seek to either undermine or corrupt any new government that took power. Given that it was precisely these individuals who represented the wealthiest elements in the early post-communist years, new governments invariably faced incentives to reach out to them for financial and political support. In any early-capitalist context, then, a new reformist or revolutionary government will eventually face pressures to provide corrupt concessions to status-quo economic actors.

The task facing a new government committed to installing effective property rights institutions is to somehow sidestep the influence of powerful status-quo interests if not eliminate them altogether. This dilemma is well-known and has received much attention throughout the literature:

Since emerging market crises are the result of political conditions, sustained growth requires an end to the close relationships between economic and political elites that distort the competitive environment and encourage the misallocation of capital. Making this transition successfully is one of the central challenges for all emerging market economies.⁴¹

But under what conditions can this actually occur? It is here where many prevailing theories of the origins of property rights institutions fall short. For, by and

⁴⁰ North, *Structure and Change in Economic History*.

⁴¹ Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Vintage, 2011), 53.

large, they fail to specify the precise mechanisms by which entrenched status-quo actors bent on preserving opportunities for predation can be emasculated and marginalized (this failure will be discussed in greater detail in a later section of the chapter).

The findings of this study suggest that the new government must take resolute action to impose hard budget constraints on all firms. Not only that, such action must be undertaken very soon after assuming power and certainly within the first one to two years.

The concept of soft versus hard budget constraints first appeared in Kornai's studies of the communist command economy.⁴² For scholars investigating the topic, the softness of the budget constraint has usually referred to whether or not a firm whose income and endowment are insufficient to meet its expenditure requirements can expect to receive outside support to cover the deficit. When outside support is not available, budget constraints are said to be hard; when it is available, budget constraints are soft. As such, the concept as conventionally used applies only to *loss-making* firms and refers to whether or not they can expect to receive external assistance. This way of looking at hard and soft budget constraints is evident not only in Kornai's work but also that of legions of successive scholars who have addressed the subject, from Erik Berglöf and Gérard Roland to Eric Maskin, Gun Eriksson Skoog, Cheng-Gang Xu, and Mark Schaffer.⁴³

This study adopts a broader definition of the concept by looking at the budget constraints faced by *all* firms regardless of whether they are loss-making or profitable. As we will see, many politically-connected companies in post-communist Europe are profitable but nevertheless receive artificial, external support on grounds that have no basis in economic rationality; indeed, this external support accounts for much of their profitability in the first place. Thus, the current investigation will consider a budget constraint to be soft when *any* organization, whether loss-making or profitable, can rely on external assistance to artificially boost its income, reduce its expenditure, or provide credit in ways that are not economically rational. An organization that faces hard budget constraints can meet its expenses only by relying on its own capital and revenues or by accessing additional financing provided exclusively on the basis of its capital and revenues.

⁴² János Kornai, "Resource-Constrained Versus Demand-Constrained Systems," *Econometrica* 47, no. 4 (1979); János Kornai, *The Economics of Shortage, Vol. A* (New York: North-Holland, 1980).

⁴³ See Kornai, *The Economics of Shortage, Vol. A*, especially ch. 6; János Kornai, *The Socialist System: The Political Economy of Communism* (Princeton and Oxford: Princeton and Oxford, 1992); János Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries," *European Economic Review* 45, no. 9 (2001); János Kornai, Eric S. Maskin, and Gérard Roland, "Understanding the Soft Budget Constraint," *Journal of Economic Literature* 41, no. 4 (2003); Erik Berglöf and Gérard Roland, "Soft Budget Constraints and Banking in Transition Economies," *Journal of Comparative Economics* 26, no. 1; Eric Maskin and Chenggang Xu, "Soft Budget Constraint Theories: From Centralization to the Market," *Economics of Transition* 9, no. 1 (2001); Mark E. Schaffer, "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence," *Journal of Comparative Economics* 26, no. 1 (1998); Gun Eriksson Skoog, *The Soft Budget Constraint: The Emergence, Persistence and Logic of an Institution* (Dordrecht: Kluwer Academic: 2000). Mitchell expands the definition of a soft budget constraint to include external support to any firm with either a negative net-present value or whose assets, once the firm is in default, could be better deployed elsewhere. But she still does not come close to the broad definition adopted here. See Janet Mitchell, "Theories of Soft Budget Constraints and the Analysis of Banking Crises," *Economics of Transition* 8, no. 1 (2000): 66.

As this study will show, the post-communist world is full of examples of profitable companies that continuously receive artificial external support without any economically reasonable justification. Once the concept is expanded in this manner, we can readily observe other examples of soft budget constraints not typically considered in discussions of the subject. Traditionally, scholars have conceptualized soft budget constraints as taking any of the following forms. Following Kornai, these include (1) soft administrative pricing, in which firms can bargain with the state to buy their output at artificially high prices; (2) soft credits, whereby organizations can borrow on artificially relaxed terms; (3) soft taxation, which confers special tax breaks upon certain firms; and (4) subsidies, or direct transfers to economic actors from the state.⁴⁴ Moving the concept of soft budget constraints away from an exclusive focus on loss-making organizations brings into view a number of additional ways in which resources can be misallocated.

Soft subsidies, for instance, are not just about propping up loss-making coal mines by transferring to them funds from the state budget. They can also involve the enrichment of private trading firms that feed off of the mines through one-sided transactions – e.g. selling inputs at high prices and buying the resulting output at low prices. Just as the loss-making coal mine is the beneficiary of subsidies from the state, the profitable trading company, in turn, enjoys subsidies from the coal mine which artificially boost its income and reduce its expenditures. Soft subsidies are also manifest in underpriced privatizations and overpriced state contracts obtained through bribery. Likewise, soft credits do not merely include the granting of loans on easy terms to unprofitable firms. They can also involve a state bank extending a huge loan to a woefully undercapitalized yet well-connected company that would never obtain such financing under competitive market conditions. In all of these examples, the organization receiving the soft budget constraint is not necessarily a loss-making one. But it is indeed the beneficiary of artificial, external support obtained on politically- rather than economically-rational grounds.

The idea of soft budget constraints thus conceived is not simply another way of referring to “rent-seeking.” While the soft budget constraints described above are all examples of rents, the concept of rent-seeking applies to other phenomena as well. Think of monopolistic pricing arrangements or criminal gangs demanding payments for “protection” from threats that they themselves create; these are instances of rent-seeking but have nothing to do with soft budget constraints as defined above. In short, all politically-motivated soft budget constraints are rents, but not all rents are politically-motivated soft budget constraints.

What purpose is served by broadening the concept of soft and hard budget constraints in the way described in the preceding discussion? For one thing, the consequences of soft budget constraints are essentially identical regardless of whether the recipient is profitable or unprofitable. Even when extended to profitable but inefficient firms, soft budget constraints arguably generate exactly the same distorting effects as if they were granted to loss-making ones. By misallocating economic resources, they undermine the process of weeding-out inefficient enterprises that is necessary for a market economy to function.⁴⁵ They similarly encourage firms to seek political favor

⁴⁴ Kornai, *The Socialist System: The Political Economy of Communism*.

⁴⁵ Ibid.; Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries."; Stijn Claessens and R. Kyle Peters Jr., "State Enterprise Performance and Soft Budget Constraints: The

instead of greater efficiency and innovation,⁴⁶ cause an excess demand for credit,⁴⁷ and worsen the fiscal condition of the state.⁴⁸

In addition to these, this study argues that soft budget constraints have another damaging effect which has received little attention to date: the enrichment and empowerment of a class of economic predators. In an early capitalist society, these actors represent the guardians of the status quo. The particular status quo they seek to preserve is invariably one that permits them free reign to trample upon the property rights of others. Their victims in this regard are not only private economic actors but also public ones – i.e. the state. Soft budget constraints are precisely what allow them to transfer assets from the state into their own hands.

To be sure, not all criminal business interests depend on soft budget constraints to survive. Al Capone built his empire not on preferential subsidies and tax breaks but rather by capturing illegal commerce. But the conditions that created Al Capone – namely the sudden criminalization of a mainstream consumer staple such as alcohol – tend to be the exception rather than the rule. Protection rackets likewise do not require soft budget constraints to operate. But, if the four countries under study are any guide, protection rackets rarely produce enough wealth by themselves to propel those who manage them into top positions among the business elite. In Estonia, Poland, Slovakia, and Ukraine – and likely in many other early-capitalist countries as well – soft budget constraints are paramount to creating and maintaining the fortunes of elite economic criminals.

Thus, any new government that seeks to put legal property rights institutions into place must effectively counter these opponents of change. And the way to do so is to harden budget constraints. If the government does not take swift and decisive action in this direction, it is setting itself up to eventually fall under their sway. This is a dichotomous variable; the government either does or does not take action, sufficient in scope and immediacy, to sever business actors from soft budget constraints.

The period immediately following the ascendance of a reformist or revolutionary government thereby represents a “critical juncture.”⁴⁹ It is one in which the new leadership’s public support and autonomy from status-quo actors are at their maximum levels. If it fails to weaken economic predators by cutting them off from the flow of public largesse, it will eventually face overwhelming pressure to succumb to their demands. Time is of the essence; as the leadership’s honeymoon with its key supporters

Case of Bulgaria," *Economics of Transition* 5, no. 2 (1997); Schaffer, "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence." Frydman et al. agree that hard budget constraints weed out inefficient firms but only if accompanied by privatization. See Roman Frydman et al., "The Limits of Discipline. Ownership and Hard Budget Constraints in the Transition Economies," *Economics of Transition* 8, no. 3 (2000).

⁴⁶ Kornai, "Resource-Constrained Versus Demand-Constrained Systems."; Kornai et al., "Understanding the Soft Budget Constraint."

⁴⁷ Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries," 1594; Claessens and R. Kyle Peters Jr., "State Enterprise Performance and Soft Budget Constraints: The Case of Bulgaria."

⁴⁸ Claessens and R. Kyle Peters Jr., "State Enterprise Performance and Soft Budget Constraints: The Case of Bulgaria."; Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries."

⁴⁹ Ruth Berins Collier and David Collier, *Shaping the Political Arena: Critical Junctures, the Labor Movement, and Regime Dynamics in Latin America* (Princeton: Princeton, 1991).

begins to wane, the predatory agents of the status quo will gain the chance to regroup and corrupt the new rulers.

What measures, in particular, must hard budget constraints consist of? First, all subsidies not justified on economically rational grounds must be eliminated. The same is true of soft loans and other credits. This second goal requires that a system of effective banking supervision be established.⁵⁰ Proper banking supervision helps ensure that credit is extended only on the basis of the soundness of a firm's financial position and expectations of future sales while inefficient projects are liquidated rather than refinanced.⁵¹ Third, the government must eliminate special tax breaks and soft administrative pricing that have no basis in economic rationality.

As suggested above, the general rule that governments maintain hard budget constraints on firms must be qualified in one important respect. The imposition of hard budget constraints does not necessarily require a government to cut firms off from state support altogether. So long as this support is allocated in an economically rational manner and not according to political considerations, real change remains possible. The defining characteristic of rational external support is that it is provided on the condition that the recipients are sufficiently capitalized and continually prove their ability to remain profitable in a competitive marketplace. In such an environment, predatory status-quo actors will find themselves unable to compete and ultimately die off. The developmental states of Northeast Asia (for a time, at least) provided exactly this kind of rational support to firms that demonstrated an ability to compete on international markets.⁵² It is when the government starts allocating assistance on grounds other than long-term economic rationality – such as maintaining excess employment, enriching government cronies, or preventing a systemic insolvency crisis – that economic predators acquire the means to become dominant.

While the East Asian developmental states did succeed with a policy of activist state support of business, most policymakers in early-capitalist countries today are likely ill-advised to follow their example. Countries like Japan and South Korea inherited well-functioning state bureaucracies composed of professional civil servants appointed predominantly on merit rather than loyalty to the chief. As a result, they could get away with channeling state funds to targeted economic sectors without falling excessively into a pattern of corruption and cronyism⁵³ (although they certainly were not entirely lacking in that, as recent scholars have pointed out).⁵⁴ If South Korea got away with it, contemporary Congo cannot. Nor, arguably, can many other early-capitalist states that are far more capable than Congo's.

⁵⁰ Fabrizio Coricelli and Simeon Djankov, "Hardened Budgets and Enterprise Restructuring: Theory and an Application to Romania," *Journal of Comparative Economics* 29, no. 4 (2001).

⁵¹ Berglof and Roland, "Soft Budget Constraints and Banking in Transition Economies."

⁵² Chalmers A. Johnson, *Miti and the Japanese Miracle: The Growth of Industrial Policy, 1925-1975* (Palo Alto, CA: Stanford, 1982); Alice Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford, 1989); Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialisation* (Princeton, NJ: Princeton, 1990).

⁵³ See, for example, Peter B. Evans, *Embedded Autonomy: States & Industrial Transformation* (Princeton, NJ: Princeton, 1995).

⁵⁴ See, for example, David C. Kang, *Crony Capitalism: Corruption and Development in South Korea and the Philippines* (Cambridge and New York: Cambridge, 2002).

This highlights another flaw inherent in many institutionalist accounts: assuming that governments in developing countries actually can create the sweeping and complex array of rules and enforcement mechanisms that the institutionalists call for.

“Gradualism” is the oft-cited mantra of institutionalists, who advise these governments to go slow and support domestic industries as they adjust to market conditions. While it appears more just, it is probably impractical for the majority of countries in the throes of early capitalism. What’s worse, corrupt governments frequently take up the mantra of “gradualism” in order to legitimize neopatrimonialism – “we are doing the best we can, but we cannot do it all at once,” they argue – and Western proponents of these policies unwittingly give them the intellectual ammunition they need.

It is important to recognize that gradualism for Islam Karimov in Uzbekistan means something entirely different than it did for leaders in post-communist Slovenia. To the extent that reformist administrations in early-capitalist societies attempt to harden budget constraints, they should likely do so as rapidly as possible; by cutting criminal business actors off at the knees in one fell swoop, they minimize the chances that these actors can bounce back, corrupt key members of the government, and undermine the reforms. The neoliberals were wrong about a lot of things, but they may well have been right about the need for speed.⁵⁵

Stage Two: Capital Accumulation

If the new government does succumb to predatory economic interests, what exactly will it be relenting to? What do status quo actors have in mind in return for their support? It is precisely the opportunity to siphon state assets freely and without limit that status-quo economic actors covet. Make no mistake: soft budget constraints are the lifeblood of all elite economic predators, whether aristocrats, tycoons, politicians, warlords, or modern tribal chiefs. Whether or not a reformist or revolutionary (as opposed to status-quo) government comes to power and imposes hard budget constraints thus determines the character that the next stage of our early-capitalist model will take – that of capital accumulation.

Economic actors whose primary interest rests in uncertain and ineffective property rights arrangements are not generally known for their talent at producing and innovating in a competitive marketplace. They make money by squeezing private actors. But even this only goes so far. To survive and thrive, they need opportunities to pilfer state resources too. The swift imposition of hard budget constraints will cut such actors off from the very life source that sustains them: public largesse. By immediately subjecting economic actors to hard budget constraints, the new government can decisively weaken the potential economic predators who might otherwise manage to prevent real change.

Why and how are hard budget constraints important? Where soft budget constraints are freely available, they serve to enrich and empower those actors who by virtue of their political connections and other skill sets have the greatest proclivity for the

⁵⁵ See, in particular, Leszek Balcerowicz, "Institutional Change after Socialism and the Rule of Law," *Hague Journal on the Rule of Law* 1, no. 02 (2009).

use of force.⁵⁶ Where soft budget constraints remain limited, economic predators will find themselves marginalized in favor of actors better able to survive under competitive market conditions. In this study, the degree and speed with which a government implements hard budget constraints is a continuous variable.

The business actors that predominate in most early-capitalist settings tend to fall into one of three categories. Each is defined by the degree to which the actor in question relied on capital or coercion during the formative period in which she acquired her early success in business; it is this formative experience that is most likely to determine the extent of her future reliance on capital or coercion.

For the purpose of this analysis, the “formative period” cannot be delimited in any fixed manner. We cannot simply define it as the period in which she earned, say, her first million dollars. A particular businessperson may have made her first million or ten million from selling computers – a simple example of wealth earned through a capital investment. But, thanks to her political connections, she then manages to win control of a huge state enterprise in a fraudulent privatization. Even though her initial success derived from a capital investment, the subsequent privatization probably comes to dwarf the previous experience in its meaning and importance for her. As a result, the lesson she is likely to draw is that the use of coercive resources, not capital, is the key to accumulating wealth. This makes her all the more likely to rely on coercion over capital going forward. The manner in which the first million was acquired is probably more important for predicting the future behavior of a non-plutocrat worth \$10 million than it is for the billionaire plutocrat. In the latter’s case, the method used to amass the first \$100 million would likely have far greater predictive value. Thus, the definition of the “formative period” can change for a given individual as she experiences more and more success.

The key question for this investigation is whether the actor in question relied primarily on capital, coercion, or both during that formative period. This suggests three possible business actor-types. The first of these is the *entrepreneur*. Entrepreneurs achieved their early success by investing capital into building productive and efficient companies. These are the business leaders with whom we in the West are most familiar – the Bill Gates’, Steve Jobs’, and Hewletts and Packards of the world. Whether by paying fair price for privatized firms or starting companies from scratch, entrepreneurs build enterprises capable of out-competing other firms by providing the best products at the lowest price. Just like Smith and Barney before them, they made their money the old-fashioned way; they *earned* it.

The second type encompasses a group of individuals whom we will refer to as *crony capitalists*. These actors do build productive companies, either *de novo* or following a privatization, that create real economic value. But their success in business – and particularly their early success – depends to a significant extent on their political connections as well. Perhaps they operate in industries that are heavily regulated. Or they rely on state contracts and thereby require access to the political gatekeepers that

⁵⁶ Sonin makes a roughly similar argument about Russia in the 1990s. He attributes Russia’s weak property rights institutions to the desire by the oligarchs to keep these institutions weak because weak institutions enable rent-seeking opportunities on their part. The oligarchs’ preference for using weak institutions to extract rents through expropriation, in turn, was the result of their success at rent-seeking during the privatization process. Sonin, "Why the Rich May Favor Poor Protection of Property Rights."

determine success or failure in such endeavors. Whatever their rationale for seeking out political connections, the key trait shared by all crony capitalists is their dependence on both capital *and* coercive resources during their formative period.

The third type occupies a special niche in the business world. For this group, the means of coercion are not simply important to their early success but are the *only reason for it*. These individuals made their first fortune by virtue of their coercive resources alone and not by creating anything of real economic value. From that point forward, their comparative advantage lies purely in their capacity to draw upon the means of force, whether by direct violence or personal ties to the force-wielding agencies of the state. At their most benign these coercive instruments may simply involve the use of political connections to secure assets in fraudulent privatizations and rigged state tenders. At their most malign, they take the form of violence and intimidation aimed at wresting control of other people's assets. Either way, the exclusive reliance on coercion during their formative periods marks these actors out not simply as thugs but a particular breed of thug – the *political thug*.

Like an ordinary thug, a political thug employs the use of force to get what he wants. What makes the political thug distinct, however, is his reliance – indeed, dependence – on access to the state to succeed in business. Even if he does not need the state's active help to undertake the act of expropriation itself, he must still cultivate the necessary contacts within the state apparatus to obtain protection from prosecution. This is what makes the political thug a distinctly political entity and not just your everyday thug who works part-time as a bouncer. Without ample support from *the state's* agents of force, the political thug is lost. For he simply cannot survive in a truly competitive marketplace.

Different post-communist societies have adopted their own terminology to describe the new class of political thugs. Perhaps the best comes from Croatia where, playing on the French term *nouveaux riches*, they are mockingly referred to as the *nouveaux niches* – “the new nothings.”⁵⁷

While all political thugs are rent-seekers, not all rent-seekers are political thugs. What distinguishes the kind of rent-seeking that political thugs engage in is that the rents obtained require access to the use of force. Some businesspeople became very rich from rent-seeking but without relying on the collusion of state officials in the process. An example is Marcel Vichmann in Estonia. Together with other top managers at Hoiupank, he orchestrated a questionable deal in which the group bought shares in the bank and obligated Hoiupank itself to guarantee the loan they obtained to purchase the shares.

To be sure, in many cases the initial fortunes of political thugs did not come directly from access to the state's agents of force. Like Vichmann, they derived from collusive, one-sided transactions with banks or state enterprises. The role of the agent of force was simply to provide the participants with protection from prosecution or other legal penalties. Vichmann represents a relatively rare instance of a one-sided deal that did not require official protection; in fact, he fought and won a case against the government after proving he had done nothing illegal. In most instances, however, the scale of the theft along with the high amount of discretion on the part of the powers-that-be to either prosecute or not prosecute necessitates some kind of bribe or other favor.

⁵⁷ Damir Grubiša, "Political Corruption in Transitional Croatia: The Peculiarities of a Model," *Politička misao* XLII, no. 5 (2006): 69-70.

Soft budget constraints are often crucial not only to political thugs but to crony capitalists as well, particularly during their formative period in business. As we will see, a typical path to success for many crony capitalists is to obtain an asset from the state through soft budget constraints and then to turn this asset into a value-producing enterprise over time.

It must also be noted that political thugs and crony capitalists are not necessarily the only business actors that bribe officials. In many countries, entrepreneurs too are compelled to engage in a certain amount of corruption to stay in business. Periodic side payments to the health inspector, the tax auditor, and the like are simply par for the course if one wants to survive. What differentiates the entrepreneur from the other two is that, in the absence of corruption, the former would still succeed and indeed thrive. The crony capitalist and political thug *need* opportunities for corruption to make it in business. Entrepreneurs tolerate corruption; political thugs and crony capitalists depend on it.

Human nature being what it is, every society likely contains a roughly similar proportion of individuals with the proclivity to engage in the criminal use of force – would-be political thugs, so to speak. What distinguishes one society from another is the degree to which its political processes and institutions filter these individuals to the top of the business world. This is where the role of soft budget constraints enters into the causal framework. Where opportunities for soft budgets abound, whether in the form of fraudulent privatizations, rigged state tenders, or informal asset-stripping, they enrich and empower an emerging class of political thugs.

It is important to stress that not all political thugs become raiders. Some simply manage to privatize a single profitable state enterprise on the cheap and make a living off of it forever after. Others might own firms in industries in which fraudulent public tenders serve as their bread and butter. Nevertheless, with very few exceptions, all the raiders in this study for whom adequate information is available can be characterized as political thugs. All political thugs are not necessarily raiders, but most raiders tend to be political thugs.

One must keep in mind that, in categorizing a particular actor as a political thug, crony capitalist, or entrepreneur, it is the formative years of that actor's business career that matter. The distinguishing characteristic is the extent to which that individual scored her *early business success* through coercion or by a major capital investment. Political thugs by definition start their careers rich in coercive resources and poor in productive capital. Thanks to their coercive prowess, many eventually come to gain control of considerable amounts of capital. But even if this individual goes on to acquire a profitable, multi-billion dollar business, as some ultimately do, she remains for our purposes a political thug. She generally cannot, by virtue of this achievement, be said to have found God and converted to entrepreneurial capitalism.

Not everyone who started out by relying exclusively on coercive resources – the hallmark of a political thug – continues doing so in perpetuity. As noted above, many crony capitalists obtain their startup capital through illicit soft budget constraints but then use it to create productive, value-generating business operations. For the purpose of this study, both of these developments – the initial pilfering of state resources and the subsequent conversion of these resources into economic value – counts as part of the formative period that justifies that individual's categorization as a crony capitalist. For

instance, Vyacheslav Boguslayev, the Ukrainian oligarch, privatized Motor Sich, which manufactures aircraft parts, through highly questionable means in the mid-1990s. He also made money importing gas from Russia, which, as we will see, financed the rise of legions of Ukraine's political thugs. But he turned Motor Sich into a highly profitable exporter that competes successfully on world markets.⁵⁸ For this reason, Boguslayev is classified as a crony capitalist.

Although the business actors that predominate in an early capitalist context are divided here by type, the extent to which one or another type assumes predominance in the business world is a continuous variable, not a dichotomous one.

Stage Three: Capitalist Competition

To summarize, the first key variable during the elite ascendance stage is whether or not there rises to power a revolutionary or reformist government. The second variable is whether or not this new government takes resolute and immediate action to impose hard budget constraints upon economic actors. Where soft budget constraints are not sufficiently reined in, the economic environment becomes marked by an abundance of political thugs and crony capitalists.

Where political thugs, in particular, become entrenched, the result is a high incidence of criminal corporate raiding during the next phase, that of capitalist competition. Because their comparative advantage tends to rest exclusively in their access to the means of force, the proliferation of political thugs ensures that raiding will be a common occurrence. Conversely, the immediate and vigorous imposition of hard budget constraints greatly reduces the chances that budding political thugs can take root and acquire wealth and influence. Severed from their very life source, the political thugs of society prove unable to achieve much of a presence in the business world.

The above discussion highlights political thugs, as opposed to crony capitalists or entrepreneurs, as the main actors that engage in criminal corporate raiding. Given their exclusive dependence on access to the means of force to make it in business, political thugs are the natural culprits we would expect to engage in this activity.

However, our final dependent variable, the prospect that robust property rights institutions can emerge, depends not just on the prevalence of political thugs but also that of crony capitalists. Why? This study hypothesizes that robust and effective property rights institutions can only arise in an early-capitalist setting if they can develop in an environment that is relatively free of corruption. If actors can bend, break, or manipulate the rules by bribing the officials in charge of enforcing them, these rules do not stand much chance of stamping down their authority. However, political thugs are not the only business actors who rely on corruption to acquire wealth. Crony capitalists too must typically spread their influence around the political system in order to operate successfully. After all, they tend to operate in industries that are highly politicized, requiring continuous regulatory approvals, permits, licenses, and/or government contracts. To the extent that such industries are dominated by crony capitalists (or political thugs), the state officials charged with issuing these concessions will constantly

⁵⁸ Andrei Samofalov, "Chelovek s Motorom: Biznes-Istoria Viacheslava Boguslaeva," *Forbes Ukraina*, 19 August 2013.

find themselves being solicited to accept bribes. Many will find the temptation hard to resist.

The pervasive corruption that results will serve to keep nascent property rights institutions from establishing the capacity to enforce their rules in an even and impersonal manner. If the findings of this study are correct, the successful development of such institutions can only occur in the absence of powerfully-entrenched networks of political thugs and crony capitalists.

This is precisely where the role of actors enters into the analysis as a causal determinant of institutions; the efficacy of property-rights institutions ultimately depends on the relative scarcity of those actors with an interest in undermining them.

Early-capitalist societies are typically poor. If not always poor, they are certainly not rich. They can rarely afford to provide their bureaucrats with the cushy salaries and attendant benefits that similar administrators earn in advanced capitalist countries. In any early capitalist setting, then, incentives for state officials to enhance their earnings by engaging in corruption are already present. If, furthermore, the economic environment is dominated by business actors who are constantly seeking to corrupt these officials, the opportunity to take the easy bribe becomes too hard to resist.

That is not all. If business actors are continuously offering bribes and state officials are constantly taking them, then the sheer scale of corruption that results will render even the most efficient and well-run policing and judicial institutions unable to rein it in. At the very least, it will take a very long time for these institutions to acquire an effective deterrent against corruption. This was indeed the case in the West, where it took hundreds of years for state and judicial agencies to develop the bureaucratic capacity to make corruption the exception rather than the rule.

Consider a simple thought experiment: what if one were to take the Federal Bureau of Investigation as it currently exists in the United States, with all of its personnel, organization, and resources intact, and transplant it into, say, contemporary Nigeria? How far would even this most sophisticated and well-trained agency get in reining in the free-for-all of corruption that prevails in that unfortunate country?

This observer would not expect it to make much progress at all. To begin with, the FBI has the advantage of operating in a setting where criminal law-breaking already tends to be the exception rather than the rule. It therefore has the luxury of being able to concentrate its formidable law-enforcement capacities on the relatively few instances of criminal activity that do take place in the United States. No equivalent state agency in Nigeria enjoys this benefit.

How long could the FBI, with exactly the same staff and salary structure that characterize it today, operate in Nigeria before even its own personnel began sampling the tempting fruit of graft? They would now be trying to work in an environment where practically every prominent businessperson and politician is seeking corrupt protection for varied illicit or law-evading activities. In a context where criminality and law-breaking are the rule, we would probably expect the FBI to fare much more poorly in doing its job.

What, then, could be said about the prospects of the considerably less advanced, well-trained and well-paid law-enforcement agencies in an early-capitalist country like Nigeria – or, for that matter, Russia, Ukraine, Poland, Slovakia, or Estonia? In early-capitalist contexts like these, states tend to be beset by disorganization and constant

change – and all this in an setting where its officials are earning low wages. For these personnel, both the motivation and opportunity to corruptly assist criminal business activities are rife.

But this is only true to the extent that business actors (whether private businesspeople or state officials operating businesses for their own ends) are actually inclined to seek out such opportunities in the first place. As we will see, Estonia in the 1990s clearly was a society in the midst of a massive reorganization of its state agencies and institutions. Moreover, it was staffed by officials whose wages at the time were quite modest by West European standards. Had the business environment been dominated by political thugs and crony capitalists, Estonia's new bureaucratic institutions would not have stood a chance of becoming truly authoritative.

Fortunately for Estonia, and thanks to its first post-communist government, such business actors remained relatively sidelined, at least in comparison to the other three countries. In Poland, Slovakia, and Ukraine, the plutocratic elite came to be made up mostly of political thugs and crony capitalists (with far more political thugs than crony capitalists in the latter two places). Meanwhile, powerful networks of such actors were present in the non-plutocratic elite. In Estonia, this was not the case. There, entrepreneurs made up the single biggest group within the plutocratic elite. In addition, I could not find any evidence that widespread networks of political thugs and crony capitalists existed among the non-plutocratic elite. Consequently, the new institutions of the Estonian state could develop in an environment where attempts to bribe its officials were far rarer than in the other three countries. It is for this reason that Estonia's institutions eventually became robust enough to control society's criminal underbelly rather than being controlled by it.

The current study departs from the conventional wisdom that the emergence of an effective bureaucratic state *causes* economic and political actors to refrain from criminal activity. It posits the reverse – that the marginalization of those actors with a proclivity for criminality (political thugs and crony capitalists) is what allows the state in a nascent capitalist setting to develop a degree of internal bureaucratic coherence. In other words, strong property rights institutions can only develop in a society where there exists a paucity of those actors who seek to corrupt these institutions in the first place.

The Debates

During the 19th century, natural theorists engaged in heated debates over the reasons for the extraordinary diversity of biological species across the globe. One of the most important early contributors was Jean-Baptiste Lamarck. He regarded evolution as the result of continual, purposive efforts by the members of a species to develop traits that are more suitable to a changing environment. Giraffes, for instance, came to develop long necks by constantly endeavoring to stretch them upwards toward the leaves of growing trees. Once acquired, the longer necks passed onto subsequent generations. Later, Charles Darwin challenged this theory, arguing that purposive will on the part of an organism is not sufficient to induce a change in traits; instead, in the wake of an environmental disruption, those organisms with the right traits will survive and multiply while those without them will not.

The debate between Lamarck and Darwin is analogous to the contrasting approaches to institutional origination considered in this dissertation. Just as Lamarck held that the purposive efforts of living beings lead to improvements in their traits, most political-economists presume that the purposive efforts of rulers lead to improvements in institutions.

The problem with Lamarckian approaches to the origins of institutions is that they fail to adequately address when and how leaders can weaken the status-quo actors bent on sabotaging efforts to put sound institutions into place. When such actors possess great wealth and influence, even the firmest commitment on the part of the ruler will likely prove insufficient to make these institutions function properly.

Some other factor must first intervene that irreversibly weakens predatory economic actors and thus clears a path for institution-building efforts to succeed. The particular factor this study points to is hard budget constraints. In contrast to the institutional Lamarckians, the central claim of this dissertation is “Darwinian.” Darwin argued that *biological* evolution requires certain *organisms* to die off, leaving those with adaptable traits to survive. This investigation holds that *institutional* evolution requires certain *actors* – namely political thugs and crony capitalists – to die off, leaving entrepreneurs to survive. The purposive will of leaders is not sufficient to spur the successful establishment of property rights institutions; there must first occur the displacement of certain kinds of actors by others. Furthermore, just as Darwin held that competition amidst scarcity is what drives *biological* evolution, this dissertation proposes that competition amidst scarcity drives *institutional* evolution; the competition induced by hard budget constraints favors entrepreneurs over rent-seekers.

The Darwin-Lamarck analogy is not meant as a value judgment on the relative merits or significance of the two views on institutional origination. It would be the height of arrogance to imply that the views I am arguing against are as discredited as Lamarck’s while I am comparable to Darwin in the superiority of my own claims. Nor am I promoting the Social Darwinist maxim that the little people need to either sink or swim. It is merely intended to contrast the substantive assertions of two equally plausible approaches to the study of institutions. Unlike Lamarck, the views I am challenging have not been discredited. Unlike Darwin, my own hypotheses remain just that: hypotheses; eight cases spread among four countries hardly amount to the final word on the relative validity of two opposing claims. However, the analogy does illustrate the different emphases they make; the Lamarckian view implies that leaders can bring about changes in certain institutional “traits” by force of will alone while my own holds that certain “species” – namely political thugs and crony capitalists – must first become extinct.

In contrast to criminal corporate raiding, institutional origination and change has become a central concern for social scientists over the last several decades, not only in the former communist region⁵⁹ but elsewhere as well. The question returned to prominence with the 1973 publication of *The Rise of the Western World* by North and Thomas. North and Thomas were mostly concerned with the consequences of these institutions rather than their causes. They argued that an efficient property rights regime

⁵⁹ Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression."; Volkov; Andrei P. Tsygankov, "Modern at Last? Variety of Weak States in the Post-Soviet World," *Communist and Post-Communist Studies* 40, no. 4 (2007).

is crucial for long-term economic development.⁶⁰ But they did prompt many to ask what causes these institutions to arise in the first place.

Scholarly treatments of this problem have tended to divide along two lines. *Voluntarists* attribute the rise of market-supporting institutions to whether or not leaders and their subjects choose to create them. *Structuralists* point to the structural conditions that determine whether this choice will be made. However, as the following review will demonstrate, both of these approaches are fundamentally Lamarckian; whether actors can freely choose to install institutions or are instead bound by certain unalterable conditions that influence their choices, once the choice is actually made, so the assumption goes, it will bring into being the desired institutional reality.

The New Institutional Economics (NIE), pioneered in part by North himself,⁶¹ was the first school to offer an answer to the question of institutional origins. The explanation put forth by North and other NIE adherents⁶² epitomizes the voluntarist approach. In essence, they argue that any faction that manages to take over the reins of state power and put its preferred ruler into place can install the institutional arrangement of its choosing. The new ruler may face opposition from other groups interested in maintaining the status quo. But so long as the faction and its ruler have a relative power advantage, they can impose a set of effective and efficient property rights institutions.

Proponents of rational-choice institutionalism adopt an equally voluntarist line. They assert that rulers will supply property rights institutions while subjects will demand and obey them when it is in their interest to do so.⁶³ Others combine an emphasis on institutional incentives with the role of leadership. Rotberg argues that when top-level leaders behave honestly and hold subordinates to account, they set an example for others at all levels of the state and society.⁶⁴ Grindle argues a similarly voluntarist line in her book on state-building in Latin America and Africa. The economic and political crises of the 1970s and 1980s weakened state institutions across these regions. But in a few cases leaders such as Salinas in Mexico and Moi in Kenya were, seemingly through sheer grit and determination alone, able to reverse the process and increase the capacity of their respective states.⁶⁵

What unites all of these accounts is the contention that new institutions necessarily arise once the choice is made to create them. They tend not to define the

⁶⁰ Douglass C. North and Robert Paul Thomas, *The Rise of the Western World: A New Economic History* (New York: Cambridge, 1973).

⁶¹ *Ibid.*; North, *Structure and Change in Economic History*.

⁶² Harold Demsetz, "Toward a Theory of Property Rights," *The American Economic Review* 57, no. 2 (1967); Jean Ensminger, *Making a Market: The Institutional Transformation of an African Society* (New York: Cambridge, 1992).

⁶³ Terry M. Moe, "Power and Political Institutions," *Perspectives on Politics* 3, no. 2 (2005); William H. Riker and Itai Sened, "A Political Theory of the Origins of Property Rights: Airport Slots," *American Journal of Political Science* 35, no. 4 (1991). Moe complements a focus on the need for victorious insiders to resolve collective action problems among themselves in order to install their preferred institutions with an additional emphasis on the role the insiders' power plays in forcing others to accept these institutions. Nevertheless, Moe, like the others, assumes that once the winners make their choice, they can freely impose the institutions of their choosing.

⁶⁴ Robert I. Rotberg, "Leadership Alters Corrupt Behavior," in *Corruption, Global Security, and World Order*, ed. Robert I. Rotberg (Washington: The Brookings Institution, 2009).

⁶⁵ Merilee S. Grindle, *Challenging the State: Crisis and Innovation in Latin America and Africa* (Cambridge and New York: Cambridge, 1996).

particular measures that must first be undertaken – namely, the hardening of budget constraints – if institution-building efforts are to succeed.

Some sociological institutionalists have gone further, arguing that a new elite that seeks to install such institutions must possess more than a relative power advantage vis-à-vis status-quo interest groups. Trimberger posits that any new government wishing to bring about institutional change and economic development must first eliminate the power of the dominant class. Its decision to do so depends on the density of social and political ties the ruling elite shares with this class. To destroy the dominant class, the political leadership must be autonomous from it. But so long as it is autonomous, it can put into place the institutions it wants.⁶⁶

While the voluntarist approach emphasizes the choices leaders make, the structuralist view examines the conditions under which these choices will ultimately be made. Some argue that new institutions can take root only when political structures, interest group configurations, or both compel the leadership to build them.⁶⁷ Others attribute this choice to economic conditions, the reputation of courts, and the cultural salience of rule-of-law principles.⁶⁸ Acemoglu & Robinson argue that leaders will choose to install effective institutions only when they face sufficient competition, both domestically and internationally.⁶⁹ Finally, there is the oft-cited role of violent conflict, the threat of foreign war, and other major social dislocations in compelling governments to forge state institutions.⁷⁰ Nevertheless, once the choice is made to support institutional development, all of the above accounts assume these institutions can effectively be put in place. Whether and how political leaders can overcome the opposition of status-quo

⁶⁶ Ellen Kay Trimberger, *Revolution from Above: Military Bureaucrats and Development in Japan, Turkey, Egypt, and Peru* (New Brunswick, NJ: Transaction Books, 1978).

⁶⁷ Frye, *Brokers and Bureaucrats: Building Market Institutions in Russia*; Grzymała-Busse; Sandra F. Joireman, "Enforcing New Property Rights in Sub-Saharan Africa: The Ugandan Constitution and the 1998 Land Act," *Comparative Politics* 39, no. 4 (2007); Benjamin B. Smith, "Life of the Party: The Origins of Regime Breakdown and Persistence under Single Party Rule," *World Politics* 57, no. 3 (2005). Onoma also makes a predominantly structuralist account, arguing that the prevailing method of land-utilization as well as state capacity determines whether leaders choose to supply efficient property rights. Ato Kwamena Onoma, *The Politics of Property Rights Institutions in Africa* (New York: Cambridge, 2010).

⁶⁸ Katharina Pistor, "Supply and Demand for Contract Enforcement in Russia: Courts, Arbitration, and Private Enforcement," *Review of Central and East European Law* 22, no. 1 (1996).

⁶⁹ Daron Acemoglu and James Robinson, "Economic Backwardness in Political Perspective," *American Political Science Review* 100, no. 1 (2006).

⁷⁰ Joel S. Migdal, *Strong Societies and Weak States: State-Society Relations and State Capabilities in the Third World* (Princeton: Princeton, 1988); Skocpol; Charles Tilly, "War Making and State Making as Organized Crime," in *Bringing the State Back In*, ed. Peter Evans, Dietrich Rueschemeyer, and Theda Skocpol (Cambridge: Cambridge, 1985); Charles Tilly, *Coercion, Capital and European States: Ad 990 - 1992* (Malden, MA and Oxford: Blackwell, 1990). Migdal cites these social dislocations only as a necessary condition. Once this necessary condition is in place, competent bureaucrats and skilled politicians can complete the task of forging strong state institutions. Volkov (2002) notes the role violence among protection rackets played in forging Russia's post-communist state. Nevertheless, with the possible exception of Ukraine, such violence was far more marginal in the countries considered here. Stepan (1978) provides a useful corrective to the purely structuralist account. He points to the organizational strength of the ruling elite – something that is indeed within the control of agents. When an organizationally robust government confronts a weak society, it can successfully pursue state-building efforts. However, his framework cannot explain when and how a government can overcome powerful societal interest groups opposed to these efforts. See Alfred Stepan, *The State and Society: Peru in Comparative Perspective* (Princeton: Princeton, 1978).

interest groups is not addressed in any meaningful way. Instead, actor preferences are assumed to translate seamlessly into institutional outcomes.⁷¹

Importantly, not only voluntarist but most structural explanations too can be Lamarckian. This is true to the extent that the structural conditions it invokes are relevant only insofar as they determine whether or not the government *chooses* to put a set of institutions into place. The threat of foreign war, the configuration of interest groups, and economic conditions all affect the degree to which the government *wants* to see these institutions arise (just as the growth of trees induces giraffes to *want* their necks to lengthen). Structuralist accounts, like their voluntarist counterparts, still imply that the intention will necessarily bring about the desired result without requiring the dying off of certain economic species opposed to this prospect.

What if – as is almost always the case – there exist powerful political thugs and crony capitalists with an interest in keeping any new institutions weak? While most theories acknowledge this problem, they fail to work through its full ramifications. For even if a new government lacks social and political ties to such groups or is induced by structural conditions to try and install property rights institutions, *it must still deal with the fact that these status-quo interest groups are there*. Even if the new leadership initially has a relative power advantage over these groups, this power advantage will often deteriorate as the government's public support inevitably wanes. Maybe the government will be lucky enough to take power following an actual war or natural disaster that has completely destroyed the power bases of the dominant classes.⁷² Short of that, any new government intending to create robust property rights institutions will confront a host of wealthy business actors opposed to the rule of law. With time, the new leadership will face strong pressures to give in to these actors, whether to sample the fruits of wealth for themselves or prevent such groups from throwing their support behind the ruler's opponents.

The government must therefore take swift action to neutralize these powerful economic criminals. In true Darwinian fashion, it must create an environment that brings about the extinction of those with the wrong traits. Otherwise, it will find it difficult to establish truly authoritative property rights institutions. To be sure, a Bolshevik-style campaign of violence and intimidation might succeed in laying waste to any societal actors bent on preserving the status quo. But when the ultimate goal is to put efficient property rights institutions into place, such methods will prove counterproductive. Pinochet used terror in the pursuit of economic reform but it was terror against one class – labor – on behalf of another – capital. But when it comes to destroying opposition to property rights institutions, the government must instead use violence against certain capitalists – i.e. political thugs – for the sake of other members of the same class. What government can carry out mass terror against one segment of the business elite and then turn around and convince the survivors that it will henceforth remain subservient to legal guarantees on the protection of property?

How, then, can a newly-ascendant government effectively and permanently avoid re-establishing links to the dominant class and when will it rather it end up capitulating?

⁷¹ Onoma (2010) is an exception. He shows how particular policies adopted by leaders in the Ghanaian province of Akyem Abuakwa marginalized resistance among traditional chiefs to stronger property rights by incentivizing the chiefs to shift from direct to indirect land-utilization.

⁷² Migdal.

Lamarckian approaches, whether of a voluntarist or structuralist hue, fail to provide a sufficient answer.

It is important to note that not all scholars suffer from the failings of institutional Lamarckianism; some have indeed given attention to certain policies that might weaken the power of status-quo actors. But the particular measures they propose to accomplish this goal center around privatization strategy⁷³ or constitutional design.⁷⁴ However, as Chapter Two will show, cross-country differences on these variables do not line up with the different outcomes observed in this study.

Rather than privatization strategy or constitutional design, the evidence unearthed here suggests the importance of another factor: whether or not the new government subjects economic actors to hard budget constraints. By imposing hard budget constraints – and doing so within a short time after taking power – the government can cut off political thugs and crony capitalists from their very life source: the allocation on political (as opposed to economically rational) grounds of subsidies, cheap credits, tax breaks, and price controls. The result will be the political and economic marginalization of these actors and their subsequent inability to influence government decisions and undermine new institutions.

In taking such actions, the new government need not actually understand what the ultimate effects will be. In all likelihood, it will implement this policy simply in the belief that hard budget constraints are necessary for competitive markets to function (as indeed they are). We should not expect the leadership to comprehend the rather counter-intuitive notion that hard budget constraints specifically promote the emergence of legal property rights institutions. Nevertheless, the hypothesis advanced here, informed by the case-study evidence in later chapters, is that hard budget constraints will greatly aid this outcome regardless of whether they were explicitly intended to do so. And it will do so precisely by weakening the predatory economic actors who stand opposed to meaningful change.

If scholars disagree over the origins of robust property rights institutions, few have questioned their consequences. Effective institutions capable of protecting property rights are widely regarded to be the deciding factor that determines the prospects for sustained economic growth over the long-term. This is an idea harking back to Weber⁷⁵ and revived during the 1970s by proponents of the NIE.⁷⁶ Many econometric analyses have established a clear and statistically significant correlation between the robustness of property rights institutions and economic growth.⁷⁷ Those adopting case-study and other

⁷³ Schwartz and Gans-Morse; Woodruff, "Property Rights in Context: Privatization's Legacy for Corporate Legality in Poland and Russia."

⁷⁴ Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions."

⁷⁵ Weber, 238.

⁷⁶ North and Thomas.

⁷⁷ R. J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics* 106, no. 2 (1991); Stephen Knack and Philip Keefer, "Institutions and Economic Performance: Cross-Country Tests Using Alternative Institutional Measures," *Economics and Politics* 7, no. 3 (1995); Jonathan Temple, "The New Growth Evidence," *Journal of Economic Literature* 37, no. 1 (1999); D Rodrik, A. Subramanian, and F. Trebbi, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development," *Journal of Economic Growth* 9, no. 2 (2004); Edward Glaeser, Jose Scheinkman, and Andrei Shleifer, "The Injustice of Inequality," *Journal of Monetary Economics, Elsevier* 50, no. 1 (2003).

types of analyses support these conclusions.⁷⁸ By the start of the new millennium, the notion had become conventional wisdom not only among academics but also the main international financial institutions as well.⁷⁹ The consensus is clear: sustained economic growth requires strong property rights institutions.

The findings of this study are not consistent with this orthodoxy. They reveal systematic and widespread property rights violations of the most abusive kind imaginable in several countries. All of these countries have nevertheless experienced solid economic growth going on 20 years. Despite huge disparities in the effectiveness of their property rights institutions, Estonia, Poland, and Slovakia have since 1994 achieved healthy growth in real GDP in the order of 4.5 percent annually.⁸⁰ Even Ukraine, which suffered an economically disastrous first post-communist decade, subsequently averaged real annual growth of 4.4 percent from 2000 to 2012. Excluding the calamitous drop in 2009 due to the global economic crisis, its average over the same period reaches six percent annually. And these are not the only countries that have enjoyed robust growth in an environment of weak property rights protections. Albania, not typically regarded as a Northian sanctuary of efficient property rights, has since 1994 experienced an average annual growth rate of 5.6 percent, far outstripping even that of Estonia.⁸¹

Obviously, findings based on a few countries hardly amounts to an effective challenge to the well-accepted notion that property rights institutions are necessary for growth. These countries may simply be outliers. Nevertheless, they are sufficient to at least prompt the question, one that few if any specialists have even asked. After all, regardless of how strong the correlation is between robust property rights institutions and economic growth, this at most shows merely that institutions *facilitate* growth. They do not prove that these institutions are *required* for growth. Likewise, the collective case study evidence cited above, however formidable it may be, cannot conclusively demonstrate that such institutions are always and everywhere necessary in order for sustained growth to occur.

For not only do the post-communist cases identified here seem to contradict the property-rights orthodoxy; the most remarkable recent cases of long-term economic growth – China, Vietnam, and India – may in the future be regarded in the same way. China emerged from the chaos of the Mao era to experience 10-percent annual growth from 1978 to 2011. That constitutes a record spanning 33 years. Is there a China specialist in the world who would seriously argue that a well-functioning bureaucracy and judicial system were in place *before* that country's sudden economic takeoff? Only in recent years have China's commercial courts actually come to be seen as dependable

⁷⁸ Avner Greif, "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition," *The American Economic Review* 83, no. 3 (1993); North and Thomas; North, *Structure and Change in Economic History*; Douglass C. North and Barry R. Weingast, "Constitutions and Commitment: The Evolution of Institutions Governing Public Choice in Seventeenth-Century England," *The Journal of Economic History* 69, no. 4 (1989); M. Olson, "Dictatorship, Democracy, and Development," *American Political Science Review* 87, no. 3 (1993); Daron Acemoglu and James Robinson, *Why Nations Fail: The Origins of Power, Poverty and Prosperity* (New York: Crown, 2012).

⁷⁹ IBRD & The World Bank, World Development Report 202: Building Institutions for Markets (Washington: The International Bank for Reconstruction and Development [IBRD] & The World Bank, 2001).

⁸⁰ According to IMF figures, Estonia's average growth rate from 1994 to 2012 averaged 5.6 percent while those of Poland and Slovakia each averaged 4.5 percent. <http://www.imf.org/external/data.htm>

⁸¹ Again, these are IMF estimates.

outlets for resolving business disputes.⁸² India too went from four decades of marginal growth to two decades of superior growth. Was this sudden shift due to the equally sudden appearance of sound regulatory institutions and courts?⁸³ Did such institutions exist in South Korea in 1960 or Vietnam in 1990? What about Indonesia during the Suharto era? To this day, stories proliferate from China detailing horrific property rights abuses or, at the very least, arbitrary and selective law enforcement against business actors.⁸⁴ The same is true for Vietnam.⁸⁵ Surely, any definitive conclusions in this regard would require far more extensive investigation. But the sheer quantity and severity of the examples available from the anecdotal evidence hardly instill confidence in the institutionalist approach.

What verdict will future generations of scholars adopt on this question? Only time will tell. But the search for answers must begin now. If we look at the historical record, how often does rational bureaucracy exist before the occurrence of long-run capitalist development? Rather than preceding economic growth, do institutions just as often develop alongside it? Might the establishment of legal property rights actually be an effect of economic development rather than its cause? To the extent that we can observe development occurring in the absence of such institutions, under what conditions is this possible and under what alternative conditions is it not? This study cannot possibly claim to answer this question. But it is certainly a question that should be asked, studied, and analyzed.

Suppose that social scientists will in future conclude that efficient property rights institutions are not necessary for economic development. If this happens, then why study the origins of these institutions at all? Even if they do not matter for long-term growth – and we are a very long way off, if ever, from reaching that verdict – there will always be a strong moral rationale for addressing this question. During the course of my research I have seen far too well the havoc that property rights abuses can wreak on people's lives. While a skilled raider can easily squash the owner of a takeover target like an insect, the effect on that person's life can be devastating. If losing one's economic livelihood is not bad enough, consider those who end up arbitrarily prosecuted and jailed in the process. Regardless of what social science ultimately decides about the economic utility of property rights institutions, there will always exist a moral imperative to publicize the human tragedies resulting from property rights violations. In doing so, we might perhaps even prompt the adoption of practical policies that lessen the frequency with which they occur.

⁸² "Chinese groups turn to law in disputes," *Financial Times*, 13 August 2012.

⁸³ I thank Steve Fish for pointing out how unlikely it was that these countries actually possessed effective market-supporting institutions before their respective economic takeoffs. See M. Steven Fish, "Penury Traps and Prosperity Tales: Why Some Countries Escape Poverty While Others Do Not," in *The Oxford Handbook on the Politics of Development*, ed. Carol J. Lancaster and Nicolas van de Walle (Oxford: Oxford, forthcoming).

⁸⁴ "Chinese steel executive held as Rio spy probe widens," *Financial Times*, 9 July 2009; "Original sin," *The Economist*, 3 September 2009; "Guilty of Something," *The Economist*, 20 May 2010; "Dispatch: China's challenges for foreign business," *Stratfor*, 25 August 2011; "Chinese infighting: secrets of a succession war," *Financial Times*, 4 March 2012; "China's Bo dismisses downfall rumors," *Financial Times*, 9 March 2012

⁸⁵ "Farmer's fight highlights Vietnam's inequality," *Financial Times*, 25 January 2012; "Vietnamese riot police seize land," *Financial Times*, 24 April 2012; "Vietnam arrests point to grater malaise," *Financial Times*, 24 August 2012; "Land grabs rile Vietnam's farmers," *Financial Times*, 11 April 2013.

The final debate to consider concerns what measures leaders in early-capitalist countries must take in order to build successful market economies. Since the 1980s, two schools have successively dominated the study of the conditions necessary for free markets to thrive. Led by proponents of the Washington Consensus, the *policy-centric* approach highlights the need to adopt specific policies aimed at freeing the economy from the pernicious influence of the state. According to this view, when economic liberalization is implemented partially or not at all, the result is sub-optimal growth and widespread corruption. The policy-centric school enjoyed its heyday precisely during the period surrounding the transition from communist rule. As a result, it powerfully shaped the debate on how best to engineer the replacement of communist command economies with vigorous free markets. But it continued to remain a prominent approach in the field thereafter.⁸⁶

The Russian and Asian financial crises of the late-1990s brought into sharp relief the problems inherent in the policy-centric approach. Their roots of these crises were seen to lie less in the form of bad policies than weak institutions. In their wake, the *institutionalist* approach came to replace its policy-centric predecessor as the standard view among much of the social-scientific establishment. It holds that the formation of markets depends on far more than simply adopting the right policies. Rather, governments must take active steps to build the complex institutional arrangements required for modern capitalist economies to work. Foremost among these are institutions that can effectively and impartially enforce the protection of legal property rights; market participants subject to property rights abuses will be loath to put their capital at risk by making investments.⁸⁷ The rise of the institutionalist camp led to changes in the field of post-communist political economy as well; where economic stagnation and corruption prevailed, these were seen as resulting from the failure of post-communist governments to put in place sound market-supporting institutions.⁸⁸

Despite their differences, the policy-centric and institutionalist schools both share a bias toward Lamarckianism; each assumes that leaders can attain some desired outcome simply by making a concerted effort to get it done. For policy-centric theorists, the key decision rests in implementing the right policies. For institutionalists, it boils down to building institutions. The problem, once again, is that there likely exist powerful economic criminals opposed to seeing such measures come to fruition. When and how can a reformist government overcome the inevitable resistance of wealthy and influential actors determined to maintain the status quo? Which factors will tip the balance between the interests of political thugs and those more amenable to meaningful change?

⁸⁶ Åslund; Balcerowicz, "Understanding Post-Communist Transitions."; Sachs; Shleifer and Vishny; Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions."; Shleifer and Treisman.

⁸⁷ Among the more notable proponents of this view are North and Thomas; North, *Structure and Change in Economic History*; Stiglitz. But the idea goes at least as far back as Weber (1978: 238), who argues that, in order for long-term capitalist development to occur, economic actors must be able to count on a certain "calculability of obligations" when dealing with the political realm.

⁸⁸ Amsden et al; Cohen and Schwartz; Firestone, "Criminal Corporate Raiding in Russia."; Florio, "Economists, Privatization in Russia and the Waning of the Washington Consensus: A Case History."; Herrera; Johnson; Pistor, "Supply and Demand for Law in Russia."; Roland; Schwartz; Stiglitz; .; IBRD & the World Bank.

The policy-centric and institutionalist approaches fail to identify the prior measures that must be taken in order for their recommendations to actually work – in particular the marginalization of powerful economic predators. Virtually alone among policy-centric theorists, Hellman does focus on the conditions that either support or inhibit status-quo, rent-seeking actors from corrupting economic outcomes; for him, the power of rent-seekers is endogenous to the degree of overall economic liberalization the government carried out.⁸⁹ However, as the next chapter will show, differences in how far governments went with market reform writ-large – as opposed to hard budget constraints, in particular – cannot explain variations in outcome among many post-communist countries.

Just as the debate between Lamarck and Darwin applies to arguments about the origins of institutions, so it does to the question of what policy prescriptions are most appropriate. Lamarck posited that a change to the *natural* environment induces organisms to alter their traits during the course of their own lifetimes. Likewise, institutionalists like Joseph Stiglitz hold that a change in the *institutional* environment induces business and political actors to alter *their* traits; by adopting the right rules, we can compel actors to stop engaging in economic predation and start behaving in ways consistent with a functioning market economy.

Much like Darwin's theory, the current study argues that organisms – whether Venus flytraps or political thugs – cannot be expected to change their behavior in mid-life. Rather, institutional evolution requires a fundamental disruption to the competitive conditions facing business actors that forces some to die off in favor of others. In particular, the implementation of hard budget constraints is necessary to sideline political thugs and crony capitalists, thereby setting the stage for entrepreneurs – the only ones who can thrive under such conditions – to take their place.

“Change the environment, and organisms will change their traits,” predicts Lamarck; “change the rules, and political thugs will change their behavior,” predict the institutionalists. Darwinism, whether applied to nature or political economy, rejects such notions; “change the environment, and certain actors will thrive while others die.”

Even aside from its Lamarckian limitations, the institutionalist approach suffers from an excessively romantic notion of what governments in early capitalist countries can hope to achieve. The idea that the administration of Boris Yeltsin in Russia could have possibly managed to put in place an effective regulatory framework and tax system, as Stiglitz and other institutionalists have argued,⁹⁰ is rather unrealistic. They have rightly been criticized for this. “Those who won most of the battles in Russia were not, of course, the authors of a finely crafted, phased-in program of institution-building-followed-by-careful-liberalization advocated by Western critics of neoliberalism,” wrote M. Steven Fish. “Even if one assumes that such an approach to economic reform is optimal, it was scarcely possible in the post-Soviet Russian environment.”⁹¹ Stephen Kotkin asked rhetorically of these critics, “Who was supposed to have implemented their suggested state-led ‘gradualist’ policies – the millions of officials who had betrayed the

⁸⁹ Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions."

⁹⁰ Stiglitz, 133-65; Cohen and Schwartz; Herrera; Florio, "Economists, Privatization in Russia and the Waning of the Washington Consensus: A Case History."

⁹¹ M. Steven Fish, *Democracy Derailed in Russia: The Failure of Open Politics* (New York: Cambridge, 2005), 168.

Soviet state and enriched themselves in the bargain?”⁹² Implementing hard budget constraints too would have been extremely difficult under Russian conditions but at least approximated a possibility; after all, Estonia, managed to do it. What hard budget constraints offer reformist governments in resource-strapped early-capitalist countries is greater bang for their buck; by focusing their efforts on putting in place a few key policies and regulatory agencies, they can potentially undermine the capacity of status-quo actors to sabotage future institution-building initiatives.

The Darwinian approach is already gaining wider acceptance, particularly in the emerging literature that seeks to explain the financial crises that beset the developed economies beginning in 2008. To the extent that the debt-fueled speculation that led to the crises was influenced by bad policies and weak or poorly designed institutions, these were merely surface causes. As Johnson and Kwak persuasively argue in their study of the United States, the root of the problem lay more fundamentally in the rise to political prominence of a financial oligarchy in the three decades prior to the crisis. This oligarchy successfully managed to bring under its thumb the policymaking and institutional apparatus of the financial system. Accordingly, any solution must address the fact of its power and influence and not focus simply on changing the rules. Unfortunately, the 2300-page Dodd-Frank Act is centered exclusively on changing the rules rather than countering the political power of the financial actors who caused the crisis in the first place. If policies are to have their intended effects and institutions are to become authoritative, the wrong kinds of actors must first be deprived of their outsized influence.⁹³

Now that the dependent variables concerning the cross-national variations have been discussed, the final one remains: what determines whether a given business actor will adopt an efficient, corrupt, or predatory strategy toward competitors? We can conceive of two rival hypotheses that offer answers to this question. The first presumes that any one business actor maintains all these strategies in her arsenal and switches from one to another as circumstances change. In other words, depending on prevailing conditions, a business actor might respond to competition by innovating new products, acquiring a competitor through fair and legal means, or launching a criminal corporate raid. The current investigation, by contrast, finds support for a different hypothesis: that business actors choose strategies that are appropriate to their distinct backgrounds, skills, and resources, not on the basis of prevailing circumstances. Raiding another business, just like innovating new products, can involve substantial costs that only certain actors are able to bare. As a result, some will choose raiding as a primary business strategy while others will turn to innovation and efficiency.

Case Selection

Originally, I set out to choose a set of countries that would display a wide range of variation on the dependent variables across both space and time. However, the true character of the differences turned out to be wildly different from what I anticipated. But this would emerge only after I had spent months in the field.

⁹² Stephen Kotkin, *Armageddon Averted: The Soviet Collapse, 1970-2000* (Oxford and New York: Oxford, 2001), 116. Quoted in Fish, *Democracy Derailed in Russia: The Failure of Open Politics*, 168.

⁹³ Johnson and Kwak.

The project began as a comparison of Poland, Slovakia, Ukraine, and Bulgaria; at the time I was forming my plans, Estonia was not even on the radar. In Ukraine, I expected to find rampant violations of property rights from the very start of the post-communist period with no significant changes over time. Ukraine turned out to be the only country that I proved right about from the beginning. In the case of Poland, I was sure that effective property-rights institutions developed very early on and exhibited stability thereafter, having read the work of other scholars on the subject. In Slovakia and Bulgaria, I suspected I would find substantial variations over time. If my initial assumptions were correct, Slovakia initially made progress under its early reformist governments only to descend into frequent raiding and property rights abuses under the third government of Vladimír Mečiar (1994-1998). Nevertheless, I expected improvements to have resumed after 1998 when a reformist coalition ousted Mečiar's Movement for a Democratic Slovakia (HZDS). Bulgaria, according to my "plan," was to display unrestrained economic predation during the socialist era of the early- to mid-1990s. This would have been followed by the emergence of sound institutions ushered in by the reform-oriented Union of Democratic Forces, who took power in 1997.

How wrong I would be. Eighteen months of fieldwork revealed a reality that was far different than I had anticipated. The scale of criminality in Slovakia was indistinguishable from that of Ukraine; raiding was widespread, property rights institutions weak, and changes over time largely non-existent. I was further shocked to find Poland's property rights institutions functioning little better, with the only difference from Ukraine and Slovakia being the lower level of raiding among the plutocratic elite.

After spending four months in Bulgaria, I discovered that it too was essentially the same as Ukraine and Slovakia and, furthermore, featured no appreciable variation over time. However, I chose not to include it in the final study for two reasons. To begin with, while there is a reasonably broad consensus in the other countries as to who the plutocrats are, this was not so in Bulgaria, at least at the time I was there. The particular identities of those who really made up the wealthiest stratum were the subject of considerable uncertainty and speculation. This stemmed from certain developments that took place in the final years of the communist regime. In February 1990, Andrei Lukanov, a high-level communist official, became Prime Minister, replacing Todor Zhivkov, the country's longstanding and discredited communist dictator. In his short stint in power, Lukanov oversaw the systematic looting of the state. During a seven-month period in 1990, over \$2 billion in state funds was shepherded out of the country, leaving a mere \$54 million remaining in the state treasury and 60 million in old Bulgarian *levs* in the central bank.⁹⁴ However, this followed an even larger exodus of state money during the late 1980s.⁹⁵

Meanwhile, as the 1990s progressed, Bulgaria was beginning to evolve in broadly similar ways to Ukraine and Slovakia.⁹⁶ The post-communist business elite that arose in the 1990s came disproportionately from in and around the communist-era security

⁹⁴ "Robert Maxwell – King of Bulgaria," *The Guardian*, January 23, 1996.

⁹⁵ Interview with Respondent #23

⁹⁶ For a good overview of the system that emerged and which highlights many of the points I make below, see *Organized Crime in Bulgaria: Markets and Trends* (Sofia, Bulgaria: Center for the Study of Democracy, 2007), 9-37. Also see Ganev, *Preying on the State: The Transformation of Bulgaria after 1989*.

apparatus. It established itself through a vast scheme, premeditated by a relative handful of individuals, to siphon state assets through the banking system. The list of alleged “credit millionaires” – those who became rich through the ingenious practice of borrowing money and not paying it back – spans scores of notable post-communist business figures from Multigroup’s Ilya Pavlov to Hristo Alexandrov, Hristo Danov, Krassimir Stoichev, and Angel Purvanov. Under the protection and guidance of Lukanov, who remained influential after departing as Prime Minister in late 1990, state banks and newly-created private banks extended enormous amounts of money to cronies of the ruling socialists. Whenever the banks came close to running out of funds, the central bank stepped in to replenish the stash, allowing the looting to continue.⁹⁷

State-owned enterprises likewise served as a source of soft budget constraints as major business actors tunneled them through input-output schemes. The biggest and most scandalous beneficiary of these arrangements was Pavlov and Multigroup, although there were numerous others. With assistance from the state security apparatus as well as VIS, the notorious organized crime group, Multigroup extracted hundreds of millions of dollars from state firms in every sector of the economy.⁹⁸ Embargo-busting during the wars of Yugoslav succession acted to further enrich the emerging criminal elite. Again, Multigroup was regarded as the largest operator but there were many others.⁹⁹ The prominent role of smuggling in the rise of oligarchic wealth differentiated Bulgaria from the other countries.

While the emergence of the Union of Democratic Forces (SDS) in 1997 tempered these activities, persisting soft budget constraints ensured that state money continued to flow to government cronies – only the faces had now changed. For example, Daru Metal replaced Multigroup as the main recipient of sweetheart deals from the state-owned Kremikovtzi steel mill.¹⁰⁰ Importantly, criminal gangs such as VIS and SIK were forced to move away from protection rackets and into more legitimate businesses.¹⁰¹ But they continued to maintain links with the new SDS government; a SIK-linked businessman named Slavcho Hristov turned out to be the co-owner of a company alongside the son of SDS Prime Minister Ivan Kostov.¹⁰²

⁹⁷ "Multigroup Owes 91 Bn Levs in Bad Debts." *Capital Weekly*, January 26, 1998; *Partners in Crime: The Risks of Symbiosis between the Security Sector and Organized Crime in Southeast Europe* (Sofia, Bulgaria: Center for the Study of Democracy, 2004), 22-25.

⁹⁸ Tomos Packer, "Bulgaria - Prominent Bulgarian Businessman Assassinated Following Court Appearance." *WMRC Daily Analysis*, 10 March 2003; Interview with Hristo Hristov, 21 June 2007; Interviews with Tiho Bezlov, 8 June and 16 July 2007; Tony Thompson, "Bulgarian drugs gangs target UK." *The Observer*, 11 April 2004; Galina Alexandrova, "Multigroup - Symbol of the Wrong Transition in Bulgaria." *Capital Weekly*, 20 March 2003.

⁹⁹ Interview with Hristo Hristov, 21 June 2007; Misha Glenny, *The Spider Trap: Corruption, Organized Crime and Transition in the Balkans and Russia* (Lecture), Center for Global Studies, University of Illinois at Urbana-Champaign; UIUC International Video Archive; Philip Gounev, "Designated Millionaires," (Sofia, Bulgaria: 2007); *Partners in Crime: The Risks of Symbiosis between the Security Sector and Organized Crime in Southeast Europe*, 25-30.

¹⁰⁰ Ivan Mihalev, "Kremikovtzi Advertises Its Own Death for \$400,000," *Capital Weekly*, 23 January 1999

¹⁰¹ Yovo Nikolov, "War with Criminal Groups Turns into Battle for Interior Ministry." *Capital Weekly*, 9 January 1999.

¹⁰² "The Olympus Circle Is Connected With the Security Insurance Company." *Capital Weekly*, May 4, 2000.

Given the liberal availability of soft budget constraints and the attendant rise of political thugs, the fact that I found many examples of criminal corporate raiding should come as no surprise. I spoke with a number of businesspeople whose companies were attacked, either by local authorities, national authorities, or both. Additional respondents reported scores of other cases from a group of criminals who forced their way into 50-percent ownership of a marble quarry operator¹⁰³ to what one source referred to as a “corporate gangster” who takes over companies through illegal shareholders meetings and then has the police escort his new management into place.¹⁰⁴ The “reformist” Kostov government, for its part, utilized a number of state agencies in a coordinated attack on the owners of MobilTel (themselves of dubious origin).¹⁰⁵

Thus, Bulgaria appears to be a clear-cut case of rampant criminal corporate raiding executed by political thugs whose wealth derived from soft budget constraints. The problem is that neither I nor the specialists with whom I spoke could say with any certainty just who the members of the plutocratic elite really are. The reason lies in the stolen billions that disappeared during the late communist period. Much of this money began returning to Bulgaria in 2001 with the rise to power of the National Movement of Stability and Progress (NDSB) led by Simeon II, the deposed pre-communist child-king. It was the new owners of much of this missing money who provided a large chunk of the NDSB’s financial backing; they sought to repatriate it to Bulgaria and invest it under the party’s protection. Some of their names are known and a number surely belong on the list of plutocrats. But the secret, offshore origins of their wealth make it difficult to assess precisely who should and should not be included on the list. To be sure, most plutocrats in the other four countries similarly own their assets through offshore entities, but these tend to be large domestic companies. Moreover, their associations with these companies are highly visible. In contrast, a large part of Bulgaria’s stolen billions are parked in cash and foreign real estate, making it harder to determine who has how much. Consequently, it proved impossible for me to definitively measure the frequency of raiding among the Bulgarian plutocratic elite. I have little doubt that if a more certain list of plutocrats were available, it would place the country alongside Ukraine and Slovakia as having a high number of plutocratic raiders. Nevertheless, due to the aforementioned problems, I cannot back this up with sufficient evidence.

To the extent that raiding is common, it is not a particularly surprising outcome from a theoretical standpoint. This is the second reason for excluding Bulgaria. In terms of developing effective property rights institutions, Bulgaria seemingly has everything working against it. It is relatively poor, Balkan, highly criminalized, and was a late entrant to the European Union. It avoided deep economic liberalization in the early post-communist period (Table 1.1) and scores significantly worse than Estonia on indicators of regulatory quality, government effectiveness, the accountability of democratic institutions, media freedom, and civil society (Tables 1.2 AND 1.3). However, Bulgaria has done well in terms of democratization, having been rated as “free” by Freedom House every year since 1991 (also see the *Nations in Transit* measure of “electoral

¹⁰³ Interview with anonymous source.

¹⁰⁴ Interview with anonymous source.

¹⁰⁵ "Press – Review (III)", *Bulgarian News Agency*, June 30, 2001; "The New Enemy," *Capital Weekly*, May 4, 2000.

Table 1.1. Degree of Economic Liberalization (1-2 years into the transition)

	<u>Year</u>	<u>Average Score</u> (all indicators, 1990-2010) ^a	<u>% Difference from Estonia</u> (all indicators)	<u>Avg. Score</u> (removing hard budget variables)	<u>% Difference from Estonia</u> (removing hard budget variables)
Estonia	1993	2.89		2.50	
Poland	1991	2.61	-8.4%	2.50	0.0%
Slovakia	1991	2.50	-11.7%	2.25	-7.5%
Ukraine	1993	1.33	-46.8%	1.50	-30.0%
Bulgaria	1991	1.17	-51.7%	1.25	-37.5%
Czech Republic	1991	2.50	-11.7%	2.25	-7.5%

^aEach country's score is calculated in a two-step process. The first step takes the average score for all years on each of the five main EBRD Transition Indicators (scale = 1 - 4.33 with higher scores indicating greater economic liberalization). The second step takes the average of all resulting numbers across all indicators.

Source: European Bank for Reconstruction and Development (EBRD) Transition Indicators. Data available at <http://www.ebrd.com/pages/research/economics/data/macro.shtml>.

process” in Table 1.3).¹⁰⁶ Likewise, the power of its legislature vis-à-vis the executive is quite high (with the possible exception of specific powers relating to its influence over the executive, something that will be discussed in the next chapter). However, Slovakia and Poland display similar scores to Bulgaria on these indicators and also have similar levels of raiding (Table 1.4).¹⁰⁷ In short, assuming Bulgaria is a case of high-raiding (and, again, inherent measurement problems prevent a conclusive judgment in this regard), including Bulgaria in the study would not have added much theoretical leverage.

Some may still question why other, more well-known cases were not included. Why Ukraine instead of Russia? Why Slovakia and not the Czech Republic? Most Russia specialists would probably not doubt that it would feature a high level of raiding among both its plutocratic and non-plutocratic elites. There has been some excellent scholarly work over the past 15 years to suggest that certain property rights institutions – particularly the commercial courts – actually do function quite capably in Russia.¹⁰⁸

Nevertheless, this observer maintains his suspicion that a large portion of its plutocratic elite have previously engaged in criminal corporate raiding while numerous raids by the non-plutocratic elite can be found in most if not all economic sectors.

¹⁰⁶ See Freedom House’s Freedom in the World dataset (<http://www.freedomhouse.org/report-types/freedom-world>).

¹⁰⁷ See Freedom House’s Freedom in the World dataset (<http://www.freedomhouse.org/report-types/freedom-world>).

¹⁰⁸ See, for instance, Hendley et al., "Law, Relationships, and Private Enforcement: Transactional Strategies of Russian Enterprises."; Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression."

Table 1.2. World Bank Governance Indicators

<u>Variable</u>	<u>Country</u>	<u>Avg. Score (1996-2011)</u>	<u>% Difference from Estonia (1996-2011)</u>
Government Effectiveness	Estonia	0.96	
	Poland	0.57	-7.8%
	Slovakia	0.76	-3.8%
	Ukraine	-0.70	-33.1%
	Bulgaria	0.01	-18.9%
	Czech Republic	0.89	-1.3%
Pol. Stability / No Violence	Estonia	0.66	
	Poland	0.63	-0.6%
	Slovakia	0.87	4.2%
	Ukraine	-0.23	-17.8%
	Bulgaria	0.27	-7.8%
	Czech Republic	0.88	4.4%
Regulatory Quality	Estonia	1.36	
	Poland	0.79	-11.3%
	Slovakia	0.94	-8.5%
	Ukraine	-0.52	-37.6%
	Bulgaria	0.49	-17.4%
	Czech Republic	1.10	-5.2%

Source: World Bank, *Worldwide Governance Indicators* (www.govindicators.org). Scale: -2.5 – 2.5 (best)

Indeed, a recent study by Jordan Gans-Morse found that Russian firms continue to face a significant threat of expropriation at the hands of officials at all levels of the Russian state.¹⁰⁹ If true, however, the outcome would be overdetermined; there appeared to me to be too many possible factors that could explain why Russia has less raiding than Estonia. One of these is Russia's vast size, which creates a special problem for assessing the frequency of raiding among the non-plutocratic elite; even if I found a certain outcome in one part of the country, I anticipated the need to make numerous trips to other faraway reaches to see if the same result obtained in other parts. This is arguably a potential problem in Ukraine and Poland; they too are quite large compared to Slovakia and Estonia but do not come close to Russia in this regard.

Another complicating factor is its status as one of the world's biggest exporters of natural resources – oil, gas, coal, iron ore, diamonds, gold, titanium, magnesium, uranium, and others. Decades of research has shown that a large stock of natural resources is associated with increased corruption and poorer institutional quality.¹¹⁰ And

¹⁰⁹ Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression."

¹¹⁰ Fish, *Democracy Derailed in Russia: The Failure of Open Politics*; Kiren Aziz Chaudhry, *The Price of Wealth: Economies and Institutions in the Middle East* (Ithaca, NY: Cornell, 1997); Erika Weinthal and Pauline Jones Luong, "Energy Wealth and Tax Reform in Russia and Kazakhstan," *Resources Policy* 27,

Table 1.3. Nations in Transit Indicators

<u>Variable</u>	<u>Country</u>	<u>Avg. Score (1997-2012)</u>	<u>% Difference from Estonia</u>
Electoral Process	Estonia	1.67	
	Poland	1.55	2.1%
	Slovakia	1.94	-4.4%
	Ukraine	3.59	-32.0%
	Bulgaria	1.67	0.0%
	Czech Republic	2.03	-6.0%
National Democratic Governance	Estonia	2.25	
	Poland	2.41	-2.6%
	Slovakia	2.69	-7.3%
	Ukraine	4.91	-44.3%
	Bulgaria	3.52	-21.2%
	Czech Republic	2.41	-2.7%
Local Democratic Governance	Estonia	2.41	
	Poland	2.38	0.5%
	Slovakia	2.44	-0.5%
	Ukraine	5.31	-48.4%
	Bulgaria	3.06	-10.9%
	Czech Republic	1.81	9.9%
Independent Media	Estonia	1.61	
	Poland	1.81	-3.4%
	Slovakia	2.61	-16.7%
	Ukraine	4.47	-47.7%
	Bulgaria	3.53	-32.0%
	Czech Republic	2.08	-7.8%
Civil Society	Estonia	2.03	
	Poland	1.33	11.7%
	Slovakia	1.86	2.9%
	Ukraine	3.33	-21.6%
	Bulgaria	3.05	-16.9%
	Czech Republic	1.55	8.1%

Variables are scaled from 1 (best) to 7 (worst)

Sources: Adrian Karatmycky, Alexander Motyl, Amanda Schnetzer, eds., Nations in Transit: Civil Society, Democracy, and Markets in East Central Europe and the Newly Independent States (New York and Washington: Freedom House, 2001); Ditmir Bushati, ed., Nations in Transit 2009: Democratization from Central Europe to Eurasia (New York and Washington: Freedom House, 2009). Christopher Walker & Sylvana Habdank-Kolaczowska, Fragile Frontier: Democracy's Growing Vulnerability in Central and Southeastern Europe (New York and Washington: Freedom House, 2012).

no. 4 (2001); Terry Lynn Karl, *The Paradox of Plenty: Oil Booms and Petro-States* (Berkeley: University of California, 1997); Michael Ross, "Does Oil Hinder Democracy?," *World Politics* 53, no. 3 (2001).

Table 1.4. Parliamentary Powers

<u>Country</u>	<u>Parliamentary Powers Index</u>	<u>% Dif. from Estonia</u>
Bulgaria	0.78	3.0%
Czech Republic	0.81	6.0%
Estonia	0.75	0.0%
Poland	0.75	0.0%
Slovakia	0.72	-3.0%
Ukraine	0.59	-16.0%

<u>Country</u>	<u>Inflexec</u>	<u>% Dif. from Estonia</u>	<u>Instaut</u>	<u>% Dif. from Estonia</u>	<u>Specpow</u>	<u>% Dif. from Estonia</u>	<u>Instcap</u>	<u>% Dif. from Estonia</u>
Bulgaria	7	-10.0%	7	0.0%	7	22.2%	4	0.0%
Czech Republic	8	0.0%	7	0.0%	5	0.0%	6	28.6%
Estonia	8	0.0%	7	0.0%	5	0.0%	4	0.0%
Poland	7	-10.0%	6	-10.0%	5	0.0%	6	28.6%
Slovakia	6	-20.0%	7	0.0%	5	0.0%	5	14.3%
Ukraine	4	-40.0%	4	-30.0%	6	11.1%	5	14.3%

Parliamentary Powers Index: Scale: 0 to 1 (most powerful parliament)

Inflexec: Influence of the legislature over the executive. Scale: 0 to 9 (most powerful)

Instaut: Institutional autonomy of the legislature. Scale: 0 to 9 (most powerful)

Specpow: The number of "specified powers" the legislature possesses. Scale: 0 to 8 (most powerful)

Instcap: The institutional capacity of the legislature to perform its functions. Scale: 0 to 6 (most powerful)

Source: M. Steven Fish and Matthew Kroenig, The Handbook of National Legislatures: A Global Survey (New York: Cambridge, 2009). Data and codebook can be downloaded at <http://polisci.berkeley.edu/people/person/m-steven-fish>

yet, with the exception of Ukraine, which exports iron ore and coal (and even then does not come close having Russia's natural resource endowment) none of the other countries are major exporters of primary products. Other factors besides these potentially complicate an attempt to explain why Russia is worse off than other countries in post-communist Europe; it was the center of the Soviet empire, is farther from Europe geographically and culturally, is burdened by supporting a large population inhabiting regions with extremely adverse climate conditions – the list goes on and on. Ukraine not only lacks many of these complicating features.

As for the Czech Republic, it too was marked by abundant soft budget constraints in the 1990s, particularly with regard to the state banks and investment privatization funds. In addition, there was clearly a large amount of asset-stripping taking place during this period.¹¹¹ Given these legacies, it would be surprising, to say the least, if the country somehow avoided seeing the rise to prominence of political thugs and a high level of raiding. Indeed, the reader may get the sense, especially from the first few chapters, that the Czech case is somehow lurking in the background of this study. One reason, perhaps, is that I was actually planning to make a trip there as my time in Eastern Europe was coming to an end. Fortunately for me, though unfortunately for the project, I got married in the interim and could not go.

¹¹¹ Schwartz; Gould.

But even if my suspicions turned out to be true – and after 18 months of research in five countries, my predictive powers were arguably better refined than they had been when I turned out to be completely wrong about Poland, Slovakia, and Bulgaria – the finding that the Czech Republic featured a high level of raiding would not have added much value theoretically. Like Poland and Slovakia, it lies at the heart of Central Europe and was an early entrant to the EU. It underwent the same degree of economic liberalization as Slovakia did in the early post-transition years (Table 1.1). Its political system been rated as “free” by Freedom House from the start, just as Poland’s has.¹¹² Like Slovakia, it does not rank far below Estonia on the World Bank measures of government effectiveness, regulatory quality, and political stability (Table 1.2). *Nations in Transit* places the Czech Republic on a similar level to Poland on electoral process, national democratic governance, and media independence and scores it better than Estonia on local democratic governance and civil society (Table 1.3). Like Slovakia, it is richer than Estonia in terms of GDP per capita.¹¹³ And its legislature is equally if not more powerful than Estonia’s (Table 1.4). In other words, if the Czech Republic turned out to be a case of high raiding, it would not have added any theoretical insight that the other countries did not.

The Methods

Studying corruption and criminality, phenomena which necessarily remain in the shadows of public life, creates special difficulties for the researcher. Aside from the obvious potential dangers of gathering information that powerful individuals prefer go unreported, the process of collecting data can be especially arduous. So it was for this investigation. An enormous effort was required just to gather enough data to define the variations on the dependent variables; the majority of my efforts were devoted to this task alone. But that is not to take away from the work of collecting data on the explanatory variables; this too proved enormously taxing.

To document the differences on the dependent variables, this study relied on two sources. The first was semi-structured interviews. A snowball-sampling procedure was used to select respondents for the interviews. Given the sensitive nature of the research, I could not hope to rely on a formal randomization process to identify potential sources. This would have required cold-calling people who in many cases were only comfortable talking about the research topic if they had been referred by someone they knew. To this end I sought out anyone who might have knowledge of criminal corporate raiding and/or institutional corruption. The list of individuals interviewed represents a broad cross-section of occupations and backgrounds.

Some readers might be surprised to learn how readily these individuals (if approached through the proper channels) proved willing to talk about criminality among the most powerful segments the post-communist elite. The sample was by no means restricted to journalists and specialists in academia and NGOs. I found plenty of willing respondents among state officials along with businesspeople, especially those who have

¹¹² See Freedom House’s Freedom in the World dataset (<http://www.freedomhouse.org/report-types/freedom-world>).

¹¹³ Data is available from the World Bank: <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>

found themselves on the receiving end of a raid attempt. Many of these individuals were quite enthusiastic about sharing their ordeals with me.

Aside from interviews, I also examined print and online media – both in English and the primary spoken languages of the four countries. In many instances, these were used to substantiate names, dates, and other facts about specific cases of raiding and institutional corruption that I heard about in the interviews. But media sources equally alerted me to numerous cases that I did not originally learn about in my interviews.

Whenever possible, I cross-checked information obtained from an interview with either another respondent or published information. This was not always feasible. In those cases, however, I considered certain types of respondents more reliable than others. I afforded more weight to information from investigative journalists, NGO specialists, and other professional researchers than I did from private businesspeople making critical remarks about other businesspeople; the latter sorts of respondents, to a greater extent than the former, would be expected to have potential axes to grind.

These methods collectively yielded a rich bank of material. Nevertheless, some specialists might wonder why two other commonly-used sources were not employed – namely, surveys of firms along with the various quantitative indicators published by international organizations like the World Bank and Freedom House. These indicators will indeed be used to evaluate the validity of many of the independent variables examined in the next chapter. However, when it comes to assessing the degree of raiding and the robustness of property rights institutions, they fall short of their objective.

The World Bank publishes annual cross-national numbers on the rule of law and corruption.¹¹⁴ The World Economic Forum conducts surveys of businesspeople asking respondents how they would “rate the protection of property rights” in their respective countries. The survey also includes a question on the independence of the judiciary.¹¹⁵ Freedom House similarly rates post-communist countries on corruption as well as “judicial framework and independence.”¹¹⁶ The *International Country Risk Guide* evaluates the threat of “expropriation.”¹¹⁷ Finally, Transparency International compiles its popular Corruption Perceptions Index by asking experts to assess the level of corruption in a given country.¹¹⁸ Any or all of these measures might be used to run large-N cross-national analyses on the extent to which property rights institutions function properly.

However, if one compares the four countries in terms of how they rank on these indicators, they would appear to flatly contradict the findings of this study. According to the indicators, the main distinction that emerges is between Ukraine, whose ratings are suitably abysmal, and the others, which score far better (Table 1.5). This investigation, by contrast, finds that the real divide is between Estonia and the rest.

¹¹⁴ . The World Bank, “Worldwide Governance Indicators.”

¹¹⁵ Xavier Sala-i-Martin, *The Global Competitiveness Report 2011–2012* (Geneva: World Economic Forum, 2011), 390, 395.

¹¹⁶ See *Nations in Transit* data at <http://www.freedomhouse.org/report-types/nations-transit>.

¹¹⁷ See website of The PRS Group at <https://www.prsgroup.com/about-us/our-two-methodologies/icrg>.

¹¹⁸ “Corruption Perceptions Index,” (Berlin: Transparency International).

Table 1.5. Problematic Indicators of Corruption and Legal Property Rights Protections

<u>Country</u>	<u>Rule of Law</u>	<u>Control of Corruption</u>	<u>Property Rights</u>	<u>Judicial Independence</u>	<u>Judicial Framework</u>	<u>Corruption</u>	<u>Corruption Perceptions</u>
Estonia	0.9	0.8	5.5	5.3	1.5	2.3	64.0
Poland	0.6	0.4	4.5	4.3	2.5	3.3	58.0
Slovakia	0.4	0.3	4.1	2.7	2.8	3.5	46.0
Ukraine	-0.9	-0.9	2.7	2.1	6.0	6.0	26.0

Sources (left to right):

World Bank, Worldwide Governance Indicators (www.govindicators.org). Scale: -2.5 – 2.5 (best)

World Bank, Worldwide Governance Indicators (www.govindicators.org). Scale: -2.5 – 2.5 (best)

World Economic Forum, Global Competitiveness Report 2012-13. Scale: 1-7 (best)

World Economic Forum, Global Competitiveness Report 2012-13. Scale: 1-7 (best)

Freedom House, Nations in Transit 2012. Scale: 1-7 (worst)

Freedom House, Nations in Transit 2012. Scale: 1-7 (worst)

Transparency International, Corruption Perceptions Index 2012. Scale: 1-100 (best)

How to explain these contradictory conclusions? There are two major problems that beset quantitative indicators of the kind listed above.¹¹⁹ Both stem from the two sources on which all such indicators are invariably based.¹²⁰ The first consists of evaluations by country experts who are asked to rate a given country based on their evaluation of the issue at hand. The resulting indicator is compiled by averaging all evaluations that were collected. In the course of my travels to the four countries (along with Bulgaria), I spoke to a multitude of such experts. I asked them for any and all concrete examples of raiding they could provide me. In Ukraine, some of my respondents could give me a couple of examples but these were at most limited to one or two. Many individuals I consulted in Slovakia reported whispers about the nefarious dealings of major business groups such as Istrokapitál and Penta but could usually provide few details. In Poland most experts I interviewed would claim that such practices are unheard of there and occur only in places like Ukraine. But eventually I would manage to find that rare informant steeped in knowledge about corruption and able to describe case after case of raiding. The testimony of these few individuals effectively falsified the assertions of those who claimed that raiding simply does not happen.

Thus, while I interviewed many country experts, in each country there would be at most three or four people I encountered – usually investigative journalists but on occasion a businessperson or academic – who actually knew about the full extent of raiding and overall economic criminality. These individuals were not only familiar with

¹¹⁹ Hendley (2006) also criticizes the kinds of indicators discussed here, albeit for different reasons than this section will outline. In particular, she argues that “rule of law” indicators based on perceptions fail to capture the Russian reality because of the peculiar attitudes of Russians toward the law. In particular, Russian perceptions, which usually tend to view the legal system as hopeless, are at odds with the reality, which is that effective legal institutions have indeed emerged in post-communist Russia.

¹²⁰ For a list of sources used in the World Bank indicators, go to <http://info.worldbank.org/governance/wgi/resources.htm> and click on “rule of law” and “control of corruption.” All are either based on expert evaluations or surveys. The Freedom House indicators are based on the evaluations of the authors it commissions for each country, the *Nations in Transit* advisers, and Freedom House itself. In other words, they are based on the opinions of country experts. See <http://www.freedomhouse.org/report-types/nations-transit>.

the general scale of the problem but could also provide names, dates, places, and every other sordid detail I required. I was subsequently able to back up many of these examples with press reports. That said, other cases they provided were based on non-public information known only to a few individuals, in which instance the respondent usually wished to remain anonymous.

What does this say for cross-national indicators that rely on the aggregate judgments of country experts? If my experience is any guide, most experts simply do not know the true extent of the criminal property rights abuses that are occurring in their countries. Indeed, if I were to base my findings on the “average” evaluation of my respondents, I too would have concluded that there is comparably little raiding happening in Poland and Slovakia. Nevertheless, the reports of the few real experts on this topic I interviewed gives the lie to such claims. The same may indeed be true of other countries both in post-communist Eurasia and elsewhere. Expert assessments of the kind that inform the indicators above merit a serious dose of skepticism.

Surveys of firms and their owners suffer from a different yet equally alarming flaw. These surveys are useful if one wishes to measure the extent of bribery or extortion, for these activities do not typically result in the very extinction of the potential survey respondent. A criminal corporate raid, to the extent that it succeeds, does cause the respondent to cease to exist. When it comes to raiding, most victims are simply no longer around to answer the surveys. As a result, any survey that attempts to measure the extent property rights violations, even in a general sense, falls victim to a massive survivorship bias. Because they are missing an entire category of such violations and, indeed, the one containing the most important form of the phenomenon, they are unreliable as indicators of the true effectiveness of property rights institutions.

One could argue that since the survivorship bias should affect all countries equally, then any cross-national variations could be expected to reflect real differences in the measured phenomenon. This would be a highly dubious assumption to make. Survivors are no different from country experts. They are opining about something of which they very likely have no first-hand knowledge. Their resulting perception of the problem could fall victim to any number of biases that cloud the accurate assessment of the variable being measured. For instance, they could be relying on a few high-profile examples that happen to stick around in their memories (the availability bias) or recent news reported of late (the recency bias).¹²¹

The problem with relying on surveys or expert evaluations is well illustrated in *The Wire*, an HBO series that portrays the narcotics trade and its consequences in west Baltimore. In season four, the normally crime-ridden Western District is experiencing an unusually low murder rate. This is despite the fact that a new player, Marlo Stanfield, has established a dominant position over the drug trade and in the process pushed the reigning kings out of the market. Many experts in the police department conclude that the numbers are accurate; the Western is simply quiet.

The reality is far different. Stanfield’s henchmen are taking their victims into vacant, boarded-up houses, killing them there, and leaving the bodies covered in lye to accelerate the decomposition. Nobody aside from them knows where the bodies are, and

¹²¹Amos Tversky and Daniel Kahneman, "Availability: A Heuristic for Judging Frequency and Probability," 5, no. 2 (1973); Leo Postman and Laura W. Phillips, "Short-Term Temporal Changes in Free Recall," *Quarterly Journal of Experimental Psychology* 17, no. 2 (1965).

apart from a few befuddled police detectives, most assume they do not exist. Indeed, if you had conducted an expert survey of all the homicide detectives in the police department, the "aggregate" response would indeed have suggested that the murder rate is down. The same would have held in a survey of Western District residents. If, by chance, you had interviewed the dead victims (akin to expropriated businesses in this study), the aggregate response would have been a tad different. But you cannot interview dead victims, just as you cannot survey dead businesses. And many "experts" often fail to notice what is happening, since murders, just like criminal corporate raids, are typically occurring in society's subterranean, criminal underbelly, where many either do not care or do not wish to investigate.

In fact, nobody would have known about the murders had it not been for the relentless pursuit of a single detective, Lester Freemon, one of the few "natural police" in the Baltimore department. After an arduous search, he finally realized what was happening. Thanks to his discovery, 22 bodies were recovered from vacant buildings throughout the city.

I had usually to undertake months-long fishing expeditions before I would finally manage to locate the Lester Freemons of Estonia, Poland, Slovakia, and Ukraine. What they ended up telling me, especially in Poland and Slovakia, utterly falsified the aggregate data on those countries compiled by numerous international organizations.

It must be emphasized that the criticisms this discussion has raised about the reliability of quantitative indicators applies only to those that attempt to measure in some way the robustness of property rights institutions and the rule of law. The claims made here should not be construed as an indictment of all quantitative indicators, many of which are perfectly accurate measures of the phenomena they seek to describe.

The problems arise where either (1) experts are called upon to assess the extent of a phenomenon occurring in a society's illicit underworld, in which the units of observation (i.e. raiders) often go to great lengths to conceal their activities, or (2) surveys of the units of observation (i.e. the targets of raiding) are conducted and yet those units who experience the "treatment," so to speak, do not survive to tell the story. Violations of property rights come in two main forms. The first is extortion, or demands on an enterprise to relinquish a portion of its revenue in the form of a bribe or other payoff. The second is expropriation (i.e. raiding), the wholesale takeover of a firm or its elimination from existence. Surveys of firms can accurately illuminate the first problem but not the second. Indicators based on the evaluation of outside experts are inappropriate for both.

Do there exist any quantitative indicators that might be immune from these problems? A potential one is average annual capital flight. Importantly, because investors may have better knowledge of conditions on the ground than country experts, they may constitute more reliable observers of the actual scale of property rights abuses. Nevertheless, this indicator is still subject to the survivorship bias since investors making the decision to either stay or flee with their capital are necessarily those from whom it has not yet been expropriated. More fundamentally, capital flight can often be driven by factors other than political risk (which is what we would be using it to measure here). Indeed, Brada et al. find that economic considerations such as interest rates, expectations of future tax rates, and inflation as well as the ease of moving wealth abroad are far

bigger determinants of capital flight in the East European transition countries than are political risk factors.¹²²

Now that some of the more conventional methods have been discussed, I will turn to precisely how I measured the extent of raiding and the robustness of property rights institutions. To measure raiding within the plutocratic elite, I first examined annually published rankings of the richest businesspeople in each country. I then counted the number of businesspeople among the top-20 wealthiest that have engaged in at least one raid in the post-communist era. I considered all individuals appearing in the rankings for the years 2007, 2009, 2010, 2011, and 2012. (Because I was not able to obtain the 2008 rankings for Slovakia, I had to leave out that year's lists for the other countries as well.) The total number of people who make up the final list of plutocrats tends to vary for each country. The reason is that certain individuals appear in multiple years and are not counted separately. To correct for these differences, the raiding measure I compile consists not of the total *number* of raiders but rather their *percentage* out of all individuals on a particular country's list. This produces a workable indicator that can be compared across countries.

The fact that the different publications often use separate criteria for determining who to include and who to exclude from their lists presented a problem, especially when their criteria differed from my own. Some lists include foreigners while others do not. Some count siblings together and others count them separately. The guiding principle behind any adjustments I made to the published lists was my goal of evaluating *how much plutocratic wealth derived from access to the use of organized force within a given country*.

Therefore, my own practice was to include only those individuals – whether foreigners or natives – who do *most* of their business inside the country. Accordingly, I dropped Lakshmi Mittal from the Ukraine list, even though *Fokus* magazine did include him at one point (due to his ownership of steelmaker Kryvorizhstal). For the same reason, I excluded Sergei Glinka, Maksim Liksutov, and Roman Stroykov from the list of Estonia's plutocrats despite the fact that they consistently appear in *Aripäev's* rankings of the richest people in Estonia. All three made the bulk of their fortunes in Russia. In Poland, I dropped Marek Profus; although born and raised in the country, he does most of his business internationally.

In addition to people who do not conduct most of their business within the country, I also excluded siblings. Some publications list them together as a single unit even though it is clear that neither would have made it on his or her own if considered separately. The only instance in which I would have counted siblings is if it were clear that they could make the top-20 list even if considered individually (which never turned out to be true).

Aside from siblings, certain newspapers listed individuals together with their spouses and/or children (in the event that they too owned shares in the business). I generally excluded spouses and children unless they had their own business activities (like Grażyna Kulczyk, ex-wife of Polish billionaire Jan Kulczyk) or represented equal participants in the business, which they rarely did. To be included on my own list, both spouses must be capable of making it on their own their own account. For instance, even

¹²² Josef C. Brada, Ali M. Kutan, and Goran Vuksic, "Capital Flight from Central and East European Countries: Estimates and Causes," *EMG Working Paper 04-2008*, (September 2008).

though Krystyna Koelner appears together with her family in *Wprost's* rankings of the richest Poles, I evaluated her as a single individual since she is clearly the driving force behind the family empire.

I also had to deal with the issue of inheritors; in some cases, the person who originally appeared on the list died and was replaced by an inheritor. I did not consider inheritors as separate business actors unless they subsequently went on to make great fortunes of their own that were sufficient to give them the status of plutocrats (none of them did). The reason is that the inheritor's wealth, and the means by which it was made, is indistinguishable from that of the deceased; if the assets were acquired in ways that qualified the deceased as, say, a crony capitalist, this fact does not change once those assets fall into the inheritor's hands.

After the original family member died and the inheritor subsequently appeared in the published list, I did not drop the inheritor but rather evaluated her as if the deceased were still alive. After all, the fortune of the deceased remained in place and would have qualified her for inclusion in the event that she was still living; the fact of her death was purely random and therefore irrelevant for the purpose of the analysis.

Whenever I excluded anyone from a given year's top-20 list, I added someone else starting with the person in position number 21 – so long as that individual too fit my criteria for inclusion. Again, the only exceptions to this rule were inheritors, in which case the inheritor was not dropped but instead considered as a single unit with the deceased.

One may question the extent to which a newspaper's official ranking of a country's top-20 wealthiest businesspeople for a given year reflects the true ranking. The methods employed in this study are designed in a way intended to minimize any such distortions. To begin with, the question of who owns what in the four countries under investigation is for the most part a matter of public record – especially among the top-20 wealthiest actors. Put simply, if you are a billionaire or anywhere close to it in Ukraine, Poland, Slovakia, or Estonia, it is rather hard to hide yourself from public view.

While overall media freedoms have ebbed and flowed over time in Ukraine and Slovakia, the real restrictions tended to be confined to the television media, not newspapers.¹²³ Even during the relatively repressive years of Mečiar in Slovakia along with Kuchma and now Yanukovych in Ukraine, there continued to exist a healthy and vigorous print media with plenty of journalists and bloggers scraping to publish every happening, however trivial, among the super-rich. Given the constantly prying eyes of print journalists, it is rather difficult for a businessperson with loads of money to remain anonymous. Dmitro Firtash, one of Ukraine's multibillionaires, managed to do so for a time. But he was found out in due course and has appeared on the list every year since then.

There are two individuals in Slovakia (Vladimír Lexa and Alojs Lorenc) who clearly belong among the top-20 but have managed to remain (relatively) in the

¹²³ One exception to this rule in Slovakia was the passage in 2008 of a much-maligned law that requires newspapers to provide space to anyone they accuse of wrongdoing and who wishes to rebut the allegations. While, at the time, newspapers were concerned about a potential flood of reply requests, such fears largely failed to materialize. See Branislav Ondrášik, "The Slovak Press Law: History and Its Impact on Free Media," in *Beyond East and West - Two Decades of Media Transformation after the Fall of Communism* (Central European University, Budapest, Hungary: 2009). That aside, reporters are free to investigate and publish what they want, especially when it comes to the annual rankings of the wealthiest businesspeople.

background behind a front of other owners. In these two instances, I added their names to the list and dropped the bottom two individuals for each year. The phenomenon of the anonymous super-rich is far more prevalent in Bulgaria, as discussed earlier.

In the other four countries, however, the problem, to the extent that it exists at all, is relatively easy to manage. Apart from including the two aforementioned Slovak businessmen, for each country I am relying not on a single-year's ranking but rather the rankings from multiple years. The rankings for any one year might contain idiosyncrasies that result in a few actors appearing on the list who should not be present or not appearing on the list when they should be there. Over a period of six years, such idiosyncrasies should be ironed out. As a result, a compilation of rankings over a number of years will provide a far more accurate reflection of reality. Furthermore, to the extent that multiple publications compile their own rankings in a given country, I include all the business actors from every such publication.

How do the countries line up? Table 1.6 breaks down the four countries in terms of the percentage of plutocrats who have allegedly been linked to raiding. In Estonia, only 5 to 11 percent of the business actors on the various top-20 lists have allegedly engaged in at least one raid attempt.¹²⁴ The situation in Poland is not much worse; there, between 13 and 15 percent of those who appear on the lists can be classified as alleged raiders.¹²⁵ The numbers for Ukraine and Slovakia tell a far different story. In Ukraine, the percentage of plutocrats allegedly associated with raiding ranges between 35 and 45 percent while the figure for Slovakia is 47 percent.¹²⁶

A brief note is in order as to why the units of observation among the plutocratic elite consist of individual businesspeople rather than business groups. Some individuals on a country's top-20 list will be shareholders in the same business conglomerate. Why not count instead the number of *conglomerates* that have ever engaged in raiding? The point of paying special attention to the very wealthiest stratum of the elite is to assess just how much wealth has been generated, at least in part, by raiding. Consider the important distinction between a business group with multiple shareholders who have each grown sufficiently wealthy from raiding to appear on the top-20 list and a similar business group for which only one shareholder appears. The individuals from the former group each represent a tremendous amount of wealth that has at least partially derived from raiding. It thus makes sense to count them separately as individuals since we are also counting as a distinct entity the sole individual who controls the latter business group. To treat the two groups equivalently would obscure the far bigger amount of wealth the individuals from the former group have each acquired from raiding. And it would unfairly give a greater weight to the single person from the latter group who has managed to get onto the list.

Attempting to measure the incidence of raiding among the non-plutocratic elite presents its own set of challenges. In particular, the countries under examination exhibit vast disparities in population size, ranging from 1.3 million in Estonia to 44.8 million in

¹²⁴ The lists for Estonia are compiled by *Äripäev*.

¹²⁵ In Poland, *Wprost* and *Forbes Polska* each compile their own lists and were both used in this study.

¹²⁶ In Ukraine, three publications (*Korrespondent*, *Fokus*, and *Forbes Ukraina*) compile rankings of the plutocratic elite. In Slovakia, only one does (*Týden*). *Forbes Slovensko* began publishing its own list of the richest Slovaks in 2013, but due to time- and resource-constraints I could not consider rankings published after 2012.

Table 1.6. Raiding Among the Plutocratic Elite

Country	# of Alleged Raiders	Total # of Plutocrats	Alleged Raiders - %
Estonia	2 to 4	38	5.3% to 10.5%
Poland	5 to 6	39	12.8% to 15.4%
Slovakia	16	34	47.1%
Ukraine	14 to 18	40	35.0% to 45.0%

Ukraine (as of 2012). Even if raiding happened with equal frequency in both countries, one would find far fewer examples in Estonia simply by virtue of its smaller size. To compensate for this, I relied on a method that can provide comparable findings across countries and economies of widely different size. Rather than simply counting the number of raids in total, I instead divided each economy into sectors. For each country, I then counted the number of sectors in which I could observe at least one raid. Even in tiny Estonia, to the extent that raiding is widespread there, one would at the very least expect to find a single instance from each sector. This method allows small countries like Estonia to be compared to bigger countries like Slovakia (5.4 million), which in turn can be compared to still larger countries such as Poland (38.5 million) and Ukraine.

To identify which sectors to focus on, I used the *International Standard Industrial Classification of All Economic Activities (ISIC)* compiled by the United Nations. I relied on the latest version in particular (Revision 4, released in August 2008).¹²⁷ *ISIC Rev. 4* distinguishes among 21 sectors of the economy. Because 21 sectors can often be too many depending on the analyst’s purpose (as indeed it is here), *ISIC Rev. 4* contains an additional, condensed classification scheme that breaks down the economy into a much more manageable ten sector groupings.¹²⁸ Of these ten, I excluded one: “public administration, defense, education, human health, and social work activities.” The reason is that this particular sector is typically state-owned and managed. This would make it irrelevant for the purpose of counting raids (which by definition target private, not public, assets). We thus have a total of nine sectors of the economy in order to make cross-national comparisons regarding the incidence of raiding.

Once again there emerges a distinct division among the four countries in terms of the number of industries in which at least one raid can be identified (Table 1.7). Recall that, in the case of the plutocratic elite, the key difference is between Estonia and Poland, on the one hand, and Slovakia and Ukraine, on the other. Among the non-plutocratic elite it is Estonia that displays little raiding and Poland, Slovakia, and Ukraine where raiding is abundant. In each of the latter three countries, the investigation uncovered at least one raid (and usually multiple raids) in most of the nine sector groupings – seven

¹²⁷ *International Standard Industrial Classification of All Economic Activities (ISIC), Rev. 4*, ed. United Nations, Statistical Papers (New York: United Nations Department of Economic and Social Affairs). Available at <http://unstats.un.org/unsd/cr/registry/isic-4.asp>

¹²⁸ This is referred to as the “High-Level SNA/ISIC Aggregation (A*10),” which includes the following sectors: (1) Agriculture, forestry and fishing (ISIC Rev. 4 Sec. A); (2) Manufacturing, mining and quarrying and other industry (B, C, D, E); (3) Construction (F); (4) Wholesale and retail trade, transportation and storage, accommodation and food service activities (G, H, I); (5) Information and communication (J); (6) Financial and insurance activities (K); (7) Real estate activities (L); (8) Professional, scientific, technical, administration and support service activities (M, N); (9) Other services (R, S, T, U); and (10) Public administration, defense, education, human health and social work activities (O, P, Q). See *ibid.*, 274.

Table 1.7. Non-Plutocratic Raids by Country (sectors with at least 1 raid)

<u>Sector #</u>	<u>Sector Name</u>	<u>Ukraine</u>	<u>Slovakia</u>	<u>Poland</u>	<u>Estonia</u>
1	Agriculture, forestry and fishing (ISIS Rev. 4 Sec. A)	X	X		
2	Manufacturing, mining and quarrying and other industry (B, C, D, E)	X	X	X	
3	Construction (F)	X		X	
4	Wholesale and retail trade, transportation and storage, accommodation and food service activities (G, H, I)	X	X	X	X
5	Information and communication (J)	X	X	X	
6	Financial and insurance activities (K)	X	X	X	
7	Real estate activities (L)		X	X	X
8	Professional, scientific, technical, administration and support service activities (M, N)		X	X	
9	Other services (R, S, T, U)	X	X		
Total		7	8	7	2

Sector categorization comes from International Standard Industrial Classification of All Economic Activities (ISIC), Revision 4 (New York: United Nations, 2008). Available at <http://unstats.un.org/unsd/cr/registry/isic-4.asp>

each in Ukraine and Poland and eight in Slovakia. In fact, raiding is so extensive among the non-plutocrats of Poland, Slovakia, and Ukraine that I undoubtedly did not manage to identify every raid that has ever occurred there. The more I looked, the more I would find. At some point I simply had to stop my research despite having a full menu of additional candidate raids on my plate to investigate further. Otherwise I would have never sat down to write this dissertation.

The story for Estonia is quite different. Despite a multi-month investigation of the same type I used in the other three, I was only able to unearth raiding in two of the nine sector groupings.¹²⁹ This constitutes a dramatic variation of 56 percent from Poland and Ukraine (a difference of five sector groups on a nine-sector scale) and 67 percent from Slovakia (a difference of six sectors). As my investigation of Estonia progressed, the same cases seemed to come up repeatedly. This suggests that I found just about every instance of non-plutocratic raiding that has occurred there.

¹²⁹ There is one additional raid of which I am aware that happened in Estonia. But I do not know in which sector it occurred as the victim refused to talk to me.

Aside from the degree of raiding among the plutocratic and non-plutocratic elites, the third dependent variable in this study is whether or not robust, authoritative property rights institutions emerged in each country. The two most important sets of institutions in this regard are a state bureaucracy and judiciary that are professional, non-corrupt, and free from political intervention.

Two methods were employed to measure this. The first is quite simple; the presence of widespread criminal corporate raiding among the plutocratic elite, non-plutocratic elite, or both effectively falsifies any notion that there exist effective property rights institutions in a given country. The evidence uncovered in this study gives the lie to any claim that authoritative property rights institutions are present in Poland, Slovakia, and Ukraine. If they did exist, one would not be able to observe such abusive violations of property rights on so extensive a scale. It is one thing for state officials to demand bribes or for company managers to skim off the top. It is quite another to completely expropriate a firm's assets or the entirety of a shareholder's stake. Where this far more pernicious form of property-rights abuse exists, authoritative property rights institutions do not.

However, the *absence* of widespread raiding does not by itself imply the *presence* of effective property rights institutions. To the extent that raiding of this sort is not occurring on a large-scale – and the only country for which this is true is Estonia – we must still rely on additional indicators to determine if such institutions really exist.

To this end I conducted 42 interviews with Estonian state officials spanning a range of institutional domains from economic and financial regulators and tax inspectors to judges. Fourteen of these interviews were semi-structured and took place in 2008. The remaining 28 occurred in the form of structured interviews in 2014. The structured interviews from 2014 were designed to assess the robustness of state institutions in terms of three dimensions. (The specific questions are provided in Table 7.11.) The first is *bureaucratic integrity*. This refers to whether the hiring of state personnel is based on merit versus personal connections (Question 1) and whether officials are promoted for effectively executing their formal tasks as opposed to demonstrating personal loyalty to their bosses (Question 2). The second dimension is the strength of *institutional constraints on corruption* (Questions 3 to 6). This was assessed by asking respondents to estimate the probability that an official discovered to have taken a bribe would be dismissed. Two scenarios were presented: one in which the bribe has already been officially reported to the relevant authorities and an alternative in which the decision to officially disclose the crime had yet to be made. The third dimension is the *evenness of enforcement*. The system might work differently for the very powerful than for those who lack such influence, a possibility that the second dimension fails to consider. The execution of a raid, after all, does not require the entire state apparatus to be thoroughly corrupt; all the raider needs is access to the right officials at the right time to help the attack go forward. In this vein, Questions 7 and 8 asked respondents to comment on the ease with which an especially well-connected individual, such as a prominent businessperson, can corruptly influence an official decision.¹³⁰

In most instances, relying only on data from a single country might not be expected to yield any meaningful conclusion; if, say, 20 percent of respondents indicated

¹³⁰ My conceptualization of a bureaucratic (as opposed to patrimonial) state is derived from that of Weber, 941-1110.

that constraints on corruption are weak, does this represent a large or small percentage? Comparing this figure with similar ones from other countries is normally the only way to find out. In Estonia, however, the respondents almost uniformly indicated that Estonia's property rights institutions are robust. This is a definitive sign that such institutions in Estonia are indeed effective.

Because the respondents consisted of actual state officials asked to assess the behavior of other state officials in their respective agencies, the resulting data is not subject to the drawbacks that beset evaluations by outside experts. The individuals interviewed were actual insiders. They can thus be expected to possess far better knowledge of any illicit activities happening within state institutions than any outsider could. Respondents were selected through a snowball sampling procedure across several state agencies. A random sample would have proven difficult since these kinds of respondents, when asked about corruption, are far more likely to agree to be interviewed if they are referred by someone they already know.

There remains the question of why one should expect the interview subjects to answer truthfully when asked to comment on such a sensitive subject. There is by now a long-established tradition in the field of post-communist studies of carrying out interviews on corruption. Many of these interviews have relied on business elites as subjects¹³¹ but others have sought out state officials and other political elites.¹³² In my own interviews with both kinds of respondents, I have found most of them to be rather open in talking about this topic (albeit if they had been approached on the basis of a recommendation from a mutual acquaintance).

Criminal corporate raiding and official corruption necessarily pose a range of measurement problems. Nevertheless, the methods outlined above are aimed at resolving these problems to the greatest possible extent. In the end, they represent reasonably robust indicators of the particular modes of criminality that constitute the focus of this study.

Students of post-communism have already devoted much attention to the general problem of corruption and related phenomena, not to mention cross-country differences on other variables. It is to this voluminous literature that we now turn. Just how well do these explanations hold up in light of the evidence uncovered here?

¹³¹ See, for example, Stanislav Markus, "Secure Property as a Bottom-up Process: Firms, Stakeholders, and Predators in Weak States," *World Politics* 64, no. 2 (2012); Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression."; Hendley, "Assessing the Rule of Law in Russia."

¹³² See, for instance, Kathleen Collins, *Clan Politics and Regime Transition in Central Asia* (New York: Cambridge, 2006); O'Dwyer.

Chapter Two

Evaluating the Rival Hypotheses

There are a vast number of explanatory variables that can potentially explain the different outcomes in this study. To review, the countries line up two-to-two with respect to the frequency of plutocratic raiding (with Estonia and Poland on the low end and Slovakia and Ukraine on the high end), three-to-one on non-plutocratic raiding (with all but Estonia featuring high levels), and three-to-one in the development of robust property rights institutions (with Estonia again as the outlier).

This chapter will evaluate some of the most commonly-cited arguments scholars have put forth to explain these and other outcomes across the post-communist countries. Many of the variables examined below have not explicitly been put forth to account for criminal corporate raiding or the development of effective property rights institutions. Nevertheless, they can potentially serve as explanations. For those variables that can be measured quantitatively, a difference among countries of 10 percent or more in the right direction will be sufficient to place a given variable into consideration as a viable candidate.

Why 10 percent? To begin with, a mere 10-percent difference on a given independent variable is far smaller than the much larger variations observed on the dependent variables (see Chapter One). Thus, if the independent variable in question does indeed explain the cross-national variations, its effect would have to be non-linear. In other words, there must exist on this variable some critical threshold which, if crossed, makes rampant raiding and weak property rights institutions inevitable.

However, not all of the following independent variables, to the extent that they matter at all, should be expected to produce non-linear effects. In all likelihood, only some do. But in applying the 10-percent minimum to *all* variables under consideration, we are making two conservative assumptions. The first is that each and every variable is non-linear in its causal impact. The second is that, on any given variable, the aforementioned critical threshold happens to fall within the very 10-percent range that separates one set of countries from the other. And yet the probability that a given critical threshold actually does fall within any given 10-percent range is itself only 10 percent (with a 90 percent probability that the critical threshold falls somewhere on the other 90-percent of a variable's range).

When combining both conservative assumptions, the probability of falsely rejecting a candidate independent variable (that is, of falsely accepting the null

hypothesis) falls considerably *below* 10 percent. For we are assuming that (a) the variable produces non-linear effects *and* (b) the critical threshold on this non-linear variable lies within the particular 10-percent range that is observed. In allowing that a mere 10-percent difference is sufficient to prevent us from rejecting a given variable, the test we are demanding of it is rather easy to pass. And yet, we will see that the vast majority of the rival independent variables examined in this chapter still fail to meet this lax requirement.

All of the variables considered below fall into one of three categories. The first consists of policy-centric variables. These variables focus on the effect of different government policies such as economic and political liberalization. The second category is composed of institutional variables. This study will restrict the definition of an institution to a set of formal, written rules backed by effective sanctions. Informal institutions will not be included in this category. The third group is made up of miscellaneous variables ranging from culture to level of economic development. Each of these three categories will be considered in turn.

Policy-Centric Variables

Among the most commonly-cited policies scholars have invoked to explain cross-national differences among post-communist countries is the degree of economic liberalization carried out after communism's collapse. There are various ways in which economic liberalization might affect the degree of raiding and the development of property rights institutions. To begin with, many scholars have fiercely criticized economic liberalization policies of the kind advocated by the World Bank and IMF. These critics have blamed economic liberalization for everything from the Russian economic collapse to the explosion of corruption in much of the post-communist world.¹

Numerous specialists have already debunked the claim that economic liberalization sabotages a country's economic and institutional prospects.² Indeed, in the four countries examined here, economic liberalization certainly did not lead either to more raiding or weaker property rights institutions. Estonia has consistently stood out as one of the post-communist leaders in economic liberalization and yet displays robust property rights institutions and little raiding (Table 2.1).

If economic liberalization fails to produce a negative effect, nor does it appear especially positive – at least if considered as the full package of reforms advocated by the international financial institutions. To be sure, Estonia does come out ahead of Poland and Slovakia in terms of the degree to which its governments implemented overall economic liberalization. However, the difference is hardly that great and certainly not substantial enough to account for the comparably large variations on the three dependent variables (Table 2.1).

¹ See, for instance, Stephen F. Cohen, *Failed Crusade: America and the Tragedy of Post-Communist Russia* (New York: Norton, 2000).

² M. Steven Fish, "Russian Studies without Studying," *Post-Soviet Affairs* 17, no. 4 (2001); Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions."; Fish, *Democracy Derailed in Russia: The Failure of Open Politics*; Ganev, *Preying on the State: The Transformation of Bulgaria after 1989*.

Table 2.1. Degree of Economic Liberalization

	Average Score (all indicators, 1990-2010)*	% Difference from Estonia
Estonia	3.7	
Poland	3.6	-3.4%
Slovakia	3.6	-3.4%
Ukraine	2.8	-28.1%

*Each country's score is calculated in a two-step process. The first step takes the average score for all years on each of the five main EBRD Transition Indicators (scale = 1 - 4.33 with higher scores indicating greater economic liberalization). The second step takes the average of all resulting numbers across all indicators.

Source: *European Bank for Reconstruction and Development (EBRD)*, Transition Indicators (<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

Meanwhile, the differences Ukraine displays from Slovakia with regard to overall economic liberalization are comparably huge. These vast differences are not consistent with the similar outcomes the two countries share in terms of the weakness of their property rights institutions and the degree of plutocratic and non-plutocratic raiding.

Even if the different reforms are considered individually, none exhibit the kinds of differences that would be required of them in order to explain the observed cross-national variations. In particular, on none of six dimensions of reform measured by the EBRD does Slovakia muster more than a seven-percent difference from Estonia (Table 2.2).

If the degree of economic liberalization does not appear to matter what about the speed with which it was carried out? Did early liberalizers end up with less raiding and better property rights institutions? Did the opposite hold true? Estonia, Poland, and Czechoslovakia all implemented economic liberalization quite rapidly compared to many other post-communist countries. Nevertheless, if one looks at their EBRD liberalization scores one-to-two years into the transition (1991 for Poland and Slovakia; 1993 for Estonia and Ukraine), Estonia does appear to have an edge over Poland and Czechoslovakia (not to mention Ukraine). Table 2.3 presents each country's average score during the early transition period.

However, two of the six variables the EBRD includes – governance and enterprise restructuring along with price liberalization – relate precisely to whether or not hard budget constraints were imposed on firms.³ Once we remove the two indicators, the difference between Estonia and Slovakia falls to well below 10 percent while that which separates Estonia and Poland disappears entirely (Table 2.3). Rather than economic liberalization writ large, then, it was the implementation of hard budget constraints, in particular, that appears to matter most. So does speed. Estonia is an outlier only with

³ Governance and enterprise restructuring measures the existence of hard budget constraints at the enterprise level and effective tight credit policies by the government and central bank. See *Transition Report 2012: Integration across Borders* (London: European Bank for Reconstruction and Development [EBRD], 2012), 167. As for price liberalization, limits on the prices firms pay for inputs amount to another form of soft budget constraint.

Table 2.2. Degree of Economic Liberalization Broken Down by Indicator

	Country (period)	Average	% Difference from Estonia
Large scale privatisation	Estonia (1992-2010)	3.7	
	Poland (1990-2010)	3.1	-18.4%
	Slovakia (1990-2010)	3.5	-7.1%
	Ukraine (1992-2010)	2.5	-36.2%
Small scale privatisation	Estonia	4.1	
	Poland	4.2	1.0%
	Slovakia	4.1	-1.6%
	Ukraine	3.3	-23.3%
Governance and enterprise restructuring	Estonia	3.3	
	Poland	3.2	-3.3%
	Slovakia	3.1	-5.9%
	Ukraine	1.9	-40.6%
Price liberalisation	Estonia	4.3	
	Poland	4.2	-1.9%
	Slovakia	4.0	-6.7%
	Ukraine	3.6	-19.0%
Trade & foreign exchange system	Estonia	4.1	
	Poland	4.1	0.1%
	Slovakia	4.1	-1.6%
	Ukraine	3.1	-30.4%
Competition Policy	Estonia	2.8	
	Poland	2.9	2.1%
	Slovakia	2.9	3.0%
	Ukraine	2.3	-17.7%

Source: EBRD Transition Indicators (<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

regard to the extent of hard budget constraints in the initial post-communist period. It does not display any significant difference from Slovakia and Ukraine on its average score for the entire period.

Aside from economic liberalization, differences in the degree and timing of political liberalization might also play a role. Looking at the Freedom House rankings,⁴ Ukraine has been rated as only “partially free” throughout the post-communist period (except for the years 2005 to 2009 when it was “free”). The relative weakness of democratic institutions in Ukraine may account for its weak property rights institutions and high level of raiding.

An examination of the other three countries puts this hypothesis to rest. Not only Estonia but Poland and Slovakia too have attained the status of “free” throughout most, if not all, of the post-communist period. The only exceptions were Estonia in 1992 (“partially free”) and Slovakia in 1993, 1996, and 1997 (also “partially free”). The high overall levels of political liberalization would suggest that this variable cannot explain the

⁴ See Freedom House’s Freedom in the World dataset (<http://www.freedomhouse.org/report-types/freedom-world>).

Table 2.3. The Speed of Economic Liberalization (degree of liberalization 1-2 years into the transition)

	<u>Year</u>	<u>Average Score</u> (all indicators)	<u>% Difference from</u> <u>Estonia</u> (all indicators)	<u>Avg. Score</u> (removing hard budget variables)	<u>% Difference from Estonia</u> (removing hard budget variables)
Estonia	1993	2.89		2.50	
Poland	1991	2.61	-8.4%	2.50	0.0%
Slovakia	1991	2.50	-11.7%	2.25	-7.5%
Ukraine	1993	1.33	-46.8%	1.50	-30.0%
Czech Republic	1991	2.50	-11.7%	2.25	-7.5%

Source: EBRD Transition Indicators (<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

differences on the dependent variables. If political liberalization did matter, one would expect similar levels of plutocratic and non-plutocratic raiding in Estonia and Slovakia along with like degrees of non-plutocratic raiding in Estonia and Poland. Moreover, there would be a similar expectation for effective property rights institutions across the three countries. The reality is quite different.

There does remain the sticky fact that Slovakia was only “partially free” during those three years in the 1990s, just as Ukraine was. Both countries, in turn, have become victims of large-scale raiding among both elite groups. The high degree of political liberalization in Poland rules out any effect liberalization might have had on non-plutocratic raiding. Nevertheless, might Slovakia’s brief flirtation with moderate authoritarianism explain why it, like Ukraine, came to experience significant raiding among the plutocratic elite?

As the discussion in Chapter Three will show, Slovakia and Ukraine differ from the other two countries to the extent that both have generally lacked highly robust competition among political parties. By contrast, the presence of robust party competition in Poland and Estonia explains why the most visible and blatant type of illicit soft budget constraint – overt privatization fraud – were held in check. Without the opportunity to siphon the biggest state assets, the plutocratic elites of Poland and Estonia ended up being composed mostly of crony capitalists and entrepreneurs instead of political thugs. This accounts for the relatively low degree of raiding among the wealthiest elite stratum in these countries. In Ukraine and Slovakia, plentiful opportunities for siphoning the largest state assets ended up enriching and empowering an elite class of political thugs who subsequently partook quite generously in criminal corporate raiding.

Naturally, robust party competition cannot exist in the absence of democracy. Dictatorships and semi-authoritarian regimes are by definition devoid of strong political oppositions capable of constantly monitoring ruling parties and threatening their dominance. In this respect, the level of political liberalization does matter but only by specifically allowing for robust party competition. As we will see, while a necessary condition, the mere existence of democracy is not sufficient on its own for robust party competition to emerge.

What about political and economic liberalization taken together? Hellman argues that countries which either implemented both reforms completely or not at all are those that emerged as the best performers economically. Those governments that implemented reforms only partially, without going the whole way, ended up plunging their countries into a “partial reform equilibrium” from which it proved difficult to escape. Partial reform gave rise to a small but powerful elite which benefited from the initial reforms but

subsequently managed to block any further reforms in order to maintain their capacity for unconstrained rent-seeking.

Hellman divides the post-communist countries into “advanced,” “high-intermediate,” “low-intermediate,” and “slow” reformers. By his measure, rapid reforms put both Poland and Slovakia into the ranks of the advanced reformers while Estonia fell into the high-intermediate category.⁵ This would predict higher raiding and weaker property rights institutions in Estonia than in Poland and Slovakia. However, this study finds the opposite to be true.

Even if we rely on a more recently updated set of scores, the same result obtains. According to current EBRD data, Estonia came out ahead of Poland and Czechoslovakia in the extent of economic liberalization by the second year of its transition.⁶ But, as we saw above, this difference disappears once we remove the key factor highlighted in this study: the imposition of hard budget constraints (Table 2.3). Meanwhile, Freedom House ranks Estonia, Poland, and Czechoslovakia as “free” two years into their respective transitions.⁷ Whichever way one measures it, the scale and speed of economic and political liberalization writ large did not affect the outcome. One needs to drill down to specific reforms – the implementation of hard budget constraints, in particular – in order to arrive at any meaningful conclusion.

A final policy-centric variable is the degree, speed, and mode of privatization. The privatization process has perhaps received more attention from post-communist specialists than any other economic reform measure.⁸ At the outset of the transition, post-communist governments wishing to privatize could not only decide how far to take it. They likewise faced a multitude of choices on how to do it: insider sales to managers, insider sales to workers, competitive auctions to domestic buyers, competitive auctions to foreign buyers, privatization with residual stakes held by the state, and any number of voucher schemes. Likewise, they could implement privatization rapidly or gradually. Naturally, scholars have pointed to the different modes and speeds with which privatization was implemented to explain cross-country variations in economic performance, asset-stripping, and overall corruption.⁹ How well do these explanations hold up?

Scholars have directed much criticism against one form of privatization in particular: rapid voucher privatization. According to its critics, this style of privatization brought about economic disaster and an explosion in asset-stripping in Russia, the Czech

⁵ Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions," 211, 213, 225.

⁶ 1991 for Poland and Czechoslovakia and 1993 for Estonia

⁷ 1991 for Poland and Czechoslovakia and 1993 for Estonia. The year-by-year Freedom House data can be obtained at <http://www.freedomhouse.org/report-types/freedom-world>.

⁸ Hilary Appel, *A New Capitalist Order: Privatization & Ideology in Russia & Eastern Europe* (Pittsburgh, PA: University of Pittsburgh, 2004); Hanley, "Cadre Capitalism in Hungary and Poland: Property Accumulation among Communist-Era Elites."; Schwartz; Sonin, "Why the Rich May Favor Poor Protection of Property Rights."; Gould; Shleifer and Vishny, chapter 8; Brown et al; Florio, "Economists, Privatization in Russia and the Waning of the Washington Consensus: A Case History."

⁹ Hanley, "Cadre Capitalism in Hungary and Poland: Property Accumulation among Communist-Era Elites."; Schwartz.

Republic, and Slovakia. Gradual privatization by alternative methods can avert such catastrophes.¹⁰

This hypothesis is highly relevant to the current study, which points to the important role that illicit soft budget constraints, including but not limited to fraudulent privatizations, played in causing raiding and weak property rights institutions. Might rapid voucher privatization be the culprit for the high levels of privatization fraud that certain countries experienced?

One of the best variants of this argument is that of Schwartz and Gans-Morse. They distinguish rapid voucher privatization from gradual, "standard" modes such as insider sales to managers and employees and market auctions to domestic and foreign buyers. According to them, rapid voucher privatization in Czechoslovakia and its Czech successor unleashed destabilizing struggles over assets. It also led to unrestrained asset-stripping from privatized firms and privatization funds. Poland and Hungary, by contrast, implemented standard modes of privatization in gradual manner, thereby avoiding these damaging outcomes. They did so by putting firms in the hands of owners capable of restructuring them, facilitating the emergence of effective capital markets and banks, and providing a feasible chance for sound regulatory institutions to evolve. Even mixed modes comprising both voucher standard methods, as employed in Poland, are likely to succeed over pure voucher schemes.¹¹

The evidence casts doubt on this assertion. Poland, despite adopting the preferred mix of privatization strategies (with only a partial voucher component), nevertheless witnessed a veritable orgy of informal asset-stripping from firms long *before* major privatization even got off the ground.¹² This process continued into the mid-1990s and nearly brought the Polish banking system to its knees, as we will see in a later chapter. Until the mid-1990s, at least, Poland thus appeared more like a case of high asset-stripping than low asset-stripping as Schwartz and Gans-Morse characterize it. Additionally, although Slovakia initially underwent voucher privatization while still part of Czechoslovakia, it later abandoned this method in favor of gradual, standard privatization. Like Poland, then, Slovakia pursued a mix of strategies consisting of both standard and voucher privatization.

As for Estonia, the authors argue that the former-Soviet countries were bound to experience widespread asset-stripping regardless of which privatization method they adopted. This was due to the especially feeble condition of the state institutions they inherited along with the large overhang of insolvent enterprises from the communist period. However, Estonia faced these same burdens, as the chapter on that country will show. Despite this, its governments ultimately managed to carry out a clean privatization process. It also saw the development over time of an efficient capital market, well-supervised banks, and effective regulatory institutions.

All of this suggests that the speed and mode of privatization cannot account for variations in either raiding or the robustness of property rights institutions in the countries examined here. Privatization did matter. But rather than its mode or speed, the key element was the amount of fraud that characterized it. While rapid voucher privatization

¹⁰ Schwartz and Gans-Morse; Jeffrey Sachs, "Lessons of Transition: A Reform Architect Looks at What Worked - and What Didn't," *Central European Economic Review*, (25 October 1999).

¹¹ Schwartz and Gans-Morse, 294-95.

¹² Staniszki, "'Political Capitalism' in Poland."

has come under attack for enabling fraud, the post-communist experience – including the four countries under examination here – offer up more than enough examples of blatant corruption where privatization was done gradually, particularly in Slovakia under Mečiar and Ukraine under practically all of its post-communist governments. The level of fraud was thus independent of privatization mode or speed. Fraudulent privatizations, whether done rapidly or gradually, by voucher or standard methods, allowed enterprises to be siphoned off into the hands of political thugs. A mostly clean privatization process could avert this outcome, marginalizing would-be political thugs who lacked the capital to participate on fair terms. It thereby created the potential for strong property rights institutions to take root.¹³ Rapid privatization can work, as can gradual methods; the key is to harden budget constraints on any and all prospective buyers.

The question remains as to whether the successful implementation of hard budget constraints must be accompanied by privatization in order to work. This study will argue that it does not. The government can privatize but still continue propping up private firms with soft budget constraints. Or it can not privatize and still impose rigorous fiscal and financial discipline on state enterprises, letting those that do not prove viable in a competitive marketplace go out of business. Moreover, whether it privatizes quickly or slowly is largely irrelevant to whether it forces hard budget constraints upon firms.

That said, some scholars argue that, without privatization, hard budget constraints can only be partially realized; privatization is a necessary step in order for the government to credibly commit to a policy of hard budget constraints. At the very least, some argue, privatization makes the distribution of soft budget constraints more costly.¹⁴ For the purpose of this study, the key factor is whether the state allows inefficient firms – whether state- or private-owned – to fail, for only then will they cease to serve as potential piggy banks for political thugs. Even if privatization can enhance this process in limited ways (aiding revenue restructuring, in particular), a sufficiently committed government that treats hard budget constraints as a top priority can nevertheless force such measures. The Estonian example will demonstrate as much; the Pro Patria government under Mart Laar allowed the worst state-owned banks to fail and forced the remaining ones to let scores of state-owned debtor firms go out of business. Privatization may aid the process but is not a necessary condition for it to occur and hardly ensures it will happen. This becomes especially true if we widen the concept of soft budget constraints to include profitable firms as well as loss-making ones; as later chapters will show, the post-communist experience offers up a wealth of examples of privately-owned, politically-connected firms obtaining external support through cronyist ties.

¹³ Frye also stresses the role of privatization fraud in hampering property rights, although he points to a different causal mechanism than the one emphasized here. In his study of Russia, he finds that the perceived legitimacy of an owner's private property rights depends on the extent to which that owner violated the Law on Privatization. That same owner could increase the perceived legitimacy of his property rights by subsequently making good use of the asset and performing public works. See Timothy Frye, "Original Sin, Good Works, and Property Rights in Russia," *World Politics* 58, no. 4 (2006).

¹⁴ See, for example, Klaus M. Schmidt, "The Costs and Benefits of Privatization: An Incomplete Contracts Approach," *Journal of Law, Economics, and Organization* 12, no. 1 (1996); Roland. Also, Frydman et al. (2000) show that, while state-owned firms in Poland, Hungary, and the Czech Republic that faced hard budget constraints did restructure their costs, they were less likely to improve their revenue performance. Meanwhile, the state banks that lent to them were less likely to let them fail. Frydman et al., "The Limits of Discipline. Ownership and Hard Budget Constraints in the Transition Economies."

It is also important to remember that formal privatization was only one possible means by which governments could enrich their allies through illicit soft budget constraints. The preoccupation with formal privatization on the part of much of the literature is overdone. For it tends to miss the myriad alternative ways in which state assets can be siphoned, from the fraudulent provision of state contracts to the informal siphoning of state enterprises, state-owned financial institutions, and state agencies themselves. To be sure, Schwartz & Gans-Morse along with a number of other scholars¹⁵ have indeed focused attention on some of these other forms illicit soft budget constraints can assume. That said, these other manifestations of the problem have mostly remained under the radar. The current study, it is hoped, will help bring them back to their rightful place in post-communist studies.

Institutionalist Variables

If many policy-centric explanations tend not to hold up in light of the evidence, what about institutionalist accounts? The post-communist literature has pointed to a vast array of institutional variables to explain a range of phenomena. To reiterate, hardly any of these have explicitly been put forward as causes of criminal corporate raiding. Nor have many been touted as explanations for the effectiveness of property rights institutions. Nevertheless, they can still serve as the bases for potential hypotheses and must accordingly be examined.

One of the most commonly-cited institutional influences on all manner of post-communist outcomes is the effect of the European Union. Those countries that were put on the fast-track to EU membership had to fulfill a multitude of political and economic conditions if they were to eventually join. The role of EU conditionality, along with monitoring by EU institutions after the countries acceded, has been variously cited as causing faster progress on democratization and economic reform, lower corruption, and more effective law-enforcement.¹⁶ Might EU conditionality have also set in motion conditions that limited raiding and improved the prospects for authoritative property rights institutions to emerge? Considering that Poland, Slovakia, and Estonia were all placed on the fast-track to EU membership and acceded at the same time in 2004, the influence of the EU does not appear to have had any effect.

What about trade openness? Greater openness to trade could potentially level the economic playing field by imposing the harsh discipline of international competition on

¹⁵ Black et al., "Russian Privatization and Corporate Governance: What Went Wrong?"; Solnick; Ganev, *Preying on the State: The Transformation of Bulgaria after 1989*; Skąpska, "The Rule of Law, Economic Transformation and Corruption after the Fall of the Berlin Wall."

¹⁶ Stephen E. Hanson, "Defining Democratic Consolidation," in *Postcommunism and the Theory of Democracy*, ed. Richard D. Anderson et al. (Princeton: Princeton, 2001), 145-48; Jeffrey Kopstein and David A. Reilly, "Geographic Diffusion and the Transformation of the Postcommunist World," *World Politics* 53, no. 1 (2000); Andrew C. Janos, "From Eastern Empire to Western Hegemony: East Central Europe under Two International Regimes," *East European Politics & Societies* 15, no. 2 (2001); Andrew C. Janos, *East Central Europe in the Modern World: The Small States of the Borderlands from Pre- to Postcommunism* (Stanford: Stanford, 2000); S. Levitsky and L.A. Way, "Linkage Versus Leverage: Rethinking the International Dimension of Regime Change," *Comparative Politics* 38, no. 4 (2006); Gérard Roland and Thierry Verdier, "Law Enforcement and Transition," *European Economic Review, Elsevier* 47, no. 7 (2003); Jaques Rupnik, "The Postcommunist Divide," *Journal of Democracy* 10, no. 1 (1999); Vachudova.

firms owned by political thugs. With little chance of surviving in a global marketplace, one would expect such firms to be destined for extinction. However, according to the EBRD, Poland, Estonia, and Slovakia are identical in terms of their openness to trade. The hypothesis would also expect the score for Slovakia to be comparable to that of Ukraine. Yet the latter rates a full 30 percent below the former (Table 2.2).

Another set of variables concerns the institutional legacies of communist and pre-communist rule. Grosjean has traced currently prevailing cultural beliefs and values back to membership in a common pre-communist empire.¹⁷ Given that Ukraine, Poland, and Estonia all belonged to the Russian empire, this factor cannot explain the different outcomes that obtained there.

Nor can the communist legacy, when considered in its most general sense, explain the variations. All of the countries inherited the same communist legacy yet display very wide variations on the dependent variables.¹⁸ Therefore, to be considered a viable explanation, any invocation of the communist legacy must highlight the different forms it took. One possible factor is the length of time spent under communist rule. But Poland, Slovakia, and Estonia all endured roughly equal stints under communism. These similarities cannot account for the variant outcomes, either in terms of raiding or the strength of legal property rights institutions.

Rather than its duration, Kitschelt and his colleagues point to the type of communist regime that prevailed in a given country. According to them, “bureaucratic-authoritarian” and “national-accommodative” regimes of the kind variously found in Poland, Hungary, East Germany, and Czechoslovakia offered better chances for effective post-communist party systems to emerge. “Patrimonial” regimes, which existed virtually everywhere else, led to less effective party systems.

If Kitschelt et al. are correct in their classifications, the argument they propose could not explain the variant outcomes observed in this study. After all, one would expect Estonia, which bore the misfortune of suffering under the Soviet Union’s patrimonial regime, to experience just as much raiding and equally weak property rights institutions as Ukraine. Moreover, the regime types found in Czechoslovakia (bureaucratic-authoritarian) and Poland (a mix between bureaucratic-authoritarian and national-accommodative) should have yielded better outcomes in these two countries than in Estonia.¹⁹

However, perhaps Kitschelt and his collaborators got the classifications wrong. Indeed, the question of what, if any, effect the level of corruption in communist-era might have had on the divergent outcomes is particularly difficult question to answer.

¹⁷ P. Grosjean, “The Contributions of Spatial Proximity and History to Cultural Integration: A Gravity Approach,” (mimeo: UC-Berkeley, 2009). Cited in Gérard Roland, “The Long Run Weight of Communism or the Weight of Long Run History?,” in *Working Paper No. 2010/83* (New York: UNU-WIDER, 2010).

¹⁸ Hendley, for example, attributes the failure to develop Western-style legal institutions (at least as of the mid-1990s) in Russia from a cultural distrust of legal rules. See Hendley, “Legal Development in Post-Soviet Russia.” Jowitt, however, shows that this cultural attitude characterized most if not all Leninist societies. See Jowitt, *New World Disorder: The Leninist Extinction*. Kornai notes how bribery and siphoning are systemic attributes of the shortage-driven economy of socialism, legacies that would predict high levels of the same phenomena in the post-communist period. Kornai, *The Economics of Shortage, Vol. A*, chapters 4 and 8.

¹⁹ Herbert Kitschelt et al., *Post-Communist Party Systems: Competition, Representation, and Inter-Party Cooperation* (Cambridge: Cambridge, 1999).

Communist regimes were known for fostering systemic corruption.²⁰ But not all communist countries were necessarily as corrupt as others. In particular, many of my Estonian respondents – some of whom served in official state positions during the Soviet period – claimed that corruption was simply not a normal occurrence. The possible role of Estonia's history of bureaucratic rectitude will be examined more fully in chapter seven. Suffice to say, not all experts agree that this legacy actually existed.²¹

One possible indicator – albeit a highly imperfect one – suggestive of the level of communist-era corruption in the late communist period is the size of the unofficial economy. In other regions of the world, the unofficial economy would never come close to approximating a valid indicator of the scale of corruption; while related, the two are far from coterminous. But an argument can be made that they were coterminous in the communist countries of Eastern Europe and the Soviet Union. Because most if not all private economic activity was banned under communism, virtually anyone who engaged in it was operating in the informal realm. Informal economic activity on any significant scale required official protection, which in turn necessitated bribery or other forms of influence. At the same time, most if not all of the large-scale corruption among public officials involved either the theft of state property for sale on the black market or the protection of those who stole such property. As a result, the two phenomena – corruption and the informal economy – overlapped in communist countries to a degree unparalleled in the rest of the world.

Various specialists attempted to measure the size of the unofficial economy in various communist countries. However, the most frequently-used estimates – those of Kaufmann and Kaliberda as well as Johnson et al – considered the Soviet Union as a whole as a single unit instead of differentiating among its constituent parts.²² Drawing on the Berkeley-Duke collaboration on the unofficial economy, Alexeev & Pyle sought to correct this flaw. According to their data, the size of the unofficial economy as a percentage of total output in 1989 reached 6 percent in Czechoslovakia and 16 percent in Poland. However, the figures for Estonia and Ukraine – 22 percent and 25 percent, respectively – far outstrip those of the other two countries (Table 2.4).²³ This suggests that Estonia and Ukraine featured higher levels of corruption in the late-communist era than did Poland and Slovakia. Needless to say, if corruption existed on a similar scale in Estonia as it did in Ukraine, this cannot explain the widely disparate outcomes between the two countries in either in the degree of raiding or the effectiveness of property rights institutions.

²⁰ Ken Jowitt, "Soviet Neotraditionalism: The Political Corruption of a Leninist Regime," *Soviet Studies* 35, no. 3 (1983).

²¹ See Tiina Randma, "A Small Civil Service in Transition: The Case of Estonia," *Public administration and development* 21, (2001).

²² See D. Kaufmann and A. Kaliberda, "Integrating the Unofficial Economy into the Dynamics of Post-Socialist Economies: A Framework for Analysis and Evidence," in *Economic Transition in Russia and the New States of Eurasia*, ed. B. Kaminski (London: M.E. Sharpe, 1996). Also see S. Johnson, D. Kaufmann, and A. Shleifer, "The Unofficial Economy in Transition," *Brookings Papers on Economic Activity* 2, (1997). Both cited in Michael Alexeev and William Pyle, "A Note on Measuring the Unofficial Economy in the Former Soviet Republics," *William Davidson Working Paper*, no. 436 (2001).

²³ Alexeev and Pyle, "A Note on Measuring the Unofficial Economy in the Former Soviet Republics."

Table 2.4. Size of the Unofficial Economy in the Late-Communist Era

Unofficial Economy (% of Total Output, 1989)			
Country	1989 (Alexeev & Pyle)	1995 (Johnson et al.)	1995 (Alexeev & Pyle)
Azerbaijan	32.8		
Georgia	32.8		
Kazakhstan	32.8		
Uzbekistan	32.8		
Belarus	28.6		
Moldova	28.6		
Hungary	27.0		
Ukraine	25.3	48.9	56.5
Bulgaria	22.8		
Romania	22.3		
Estonia	22.1	11.8	21.9
Latvia	22.1		
Lithuania	22.1		
Russia	18.0		
Poland	15.7	12.6	no estimate
Czech Republic	6.0		
Slovakia	6.0	5.8	no estimate

Sources: Alexeev & Pyle (2001, Tables 2 & 6); Johnson, Kaufman & Shleifer (1997).

However, this conclusion must be taken with a serious grain of salt. To begin with, by the late 1980s, Poland already had a substantial private sector by 1989 amounting to 28 percent of total output.²⁴ As a result, not all private economic activity counted as part of the unofficial economy and accordingly did not necessarily require the corrupt protection of state officials. Furthermore, to the extent that the grey economy was coterminous with the degree of corruption, arriving at an accurate measure of either of these is a chancy proposition at best. What the above indicator amounts to is using one murky and difficult-to-measure phenomenon – the grey economy – to measure another murky and difficult-to-measure phenomenon – the level of corruption. It hardly provides grounds for a definitive judgment on the true extent of corruption under communism. But while not a definitive indicator, it is enough to create some doubt over the supposed bureaucratic rectitude of the late-communist Estonian state.

Even assuming that Estonia did inherit a legacy of honest bureaucratic governance, it likely played a role only by first influencing the decision of the post-communist Estonian government to impose hard budget constraints. As later chapters will show, criminal corporate raiding tends to be the work exclusively of political thugs. And political thugs depend on soft budget constraints as their primary source of sustenance. One would expect that a tradition of corrupt rule would increase the probability that a country's leaders would use soft budget constraints to build and maintain patronage networks. Likewise, a tradition of bureaucratic statehood might limit this tendency and thereby make the adoption of hard budget constraints more feasible. It might potentially have exerted an independent effect on the ability of political thugs to

²⁴ Michael S. Borish and Michel Noël, "Private Sector Development in the Visegrad Countries,," *Finance & Development*, December 1996, 46.

engage in criminal corporate raiding; to the extent that the bribery of state officials is necessary to undertake raids, a legacy of honest governance would have made this more difficult. But while it could have potentially had an independent effect on the capacity for raiding, it cannot independently account for the relative absence of those actors who typically engage in raiding – not without first influencing the decision to harden budget constraints. Clearly, then, the role of hard and soft budget constraints is key in explaining differences across countries in the relative presence of political thugs.

Likewise, we can also put to rest the notion that the size of the informal economy itself, regardless of any corruption it indicates, caused the different outcomes. Azam et al. argue that the incentives for opportunistic governments to engage in predatory behavior varies according to the size of the formal sector. It is always easier to expropriate businesses operating in the formal economy since they are more visible. Thus, where the formal sector is small (and the informal sector large), governments can more easily exploit firms in the formal economy because they are too few in number to pose much resistance. As the formal sector grows, however, governments will find it harder and harder to beat down economic actors in this realm given that they are increasing in number and, by extension, political influence.²⁵ We would thus expect more raiding in countries with large informal (i.e. small formal) sectors and less raiding in countries with small informal (i.e. large formal) sectors. However, according to Johnson et al. (1997), as of 1995, informal sectors were similarly sized in Poland, Slovakia, and Estonia (and far larger in Ukraine). If one relies on Alexeev & Pyle's (2001) estimates, Estonia's informal sector was significantly larger than those of Poland and Slovakia in 1995, which would lead to the expectation of more raiding in Estonia (Table 2.4).²⁶ Clearly, the relative size of the formal and informal sectors had no impact on the scale of asset expropriation.

Aside from the communist legacy, there is the potential effect of various institutions that sprouted after communism's collapse. Indeed, the view that poorly-designed institutions do not bode well for a country's political and economic development has begun to gain wide acceptance over the past two decades.²⁷ To the extent that institutions are badly designed and disorganized, raiders can potentially exploit them to extract rents and ensnare takeover targets in impossible webs of red tape.

Beginning in 1996, the World Bank began compiling a range of governance indicators. They are based on a scale of -2.5 to 2.5 with 2.5 representing the best possible score. Two of these indicators – *rule of law* and *control of corruption* – conceptually overlap with other variables included in this study's causal framework and were examined in the previous chapter. But scores are available on a number of additional indicators that might potentially play a significant causal role.²⁸

²⁵ Azam et al., "Political Predation and Economic Development."

²⁶ Alexeev & Pyle do not provide their own estimates for Poland or Slovakia for 1995. This comparison thus relies on the Johnson et al. numbers for these two countries.

²⁷ . IBRD and The World Bank, *World Development Report 2002: Building Institutions for Markets* (Washington: The International Bank for Reconstruction and Development (IBRD) & The World Bank, 2001).

²⁸ . "Worldwide Governance Indicators," (Washington: The World Bank, www.govindicators.org).

Table 2.5. World Bank Governance Indicators

<u>Variable</u>	<u>Country</u>	<u>Avg. Score (1996-2011)</u>	<u>% Difference from Estonia (1996-2011)</u>
Government Effectiveness	Estonia	0.96	
	Poland	0.57	-7.8%
	Slovakia	0.76	-3.8%
	Ukraine	-0.70	-33.1%
Pol. Stability / No Violence	Estonia	0.66	
	Poland	0.63	-0.6%
	Slovakia	0.87	4.2%
	Ukraine	-0.23	-17.8%
Regulatory Quality	Estonia	1.36	
	Poland	0.79	-11.3%
	Slovakia	0.94	-8.5%
	Ukraine	-0.52	-37.6%

Source: World Bank, Worldwide Governance Indicators (www.govindicators.org). Scale: -2.5 – 2.5 (best)

How well do these indicators hold up? In terms of *government effectiveness*²⁹ differences in the average scores for Estonia, Poland, and Slovakia fall well below our 10-percent threshold for significance (Table 2.5). Poland emerges only 7.8 percent worse than Estonia while Slovakia scores a mere 3.8 percent worse. It is highly unlikely that such minor differences could account for the widely different outcomes. The same is true for *political stability and [the] absence of violence*.³⁰ Here, Poland and Estonia have virtually identical scores while Slovakia emerges as 4.2 percent more stable than Estonia. Meanwhile, Poland and Slovakia score far higher than Ukraine, which could not explain the similar amounts of raiding across the three countries. Nor do the differences on *regulatory quality*³¹ provide a sufficient account of the different outcomes. Estonia comes out ahead of Slovakia by only 8.5 percent. Furthermore, Slovakia again scores much higher than Ukraine (38 percent) than the slight variations on the dependent variables warrant.

Another possible explanation might lie in the nature of the constitutional system. The evidence has long suggested that weak legislatures and powerful executives act against the consolidation of democratic regimes and foster corruption as well.³² Might

²⁹ This indicator measures “perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.”

³⁰ This indicator measures “perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism.”

³¹ This indicator measures “perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.”

³² Juan Linz, “Presidential or Parliamentary Democracy: Does It Make a Difference?,” in *The Failure of Presidential Democracy*, ed. Juan Linz and Arturo Valenzuela (Baltimore, MD: Johns Hopkins University Press: Johns Hopkins, 1994); Alfred Stepan and Cindy Skach, “Constitutional Frameworks and Democratic Consolidation: Parliamentarism Versus Presidentialism,” *World Politics* 46, no. 3 (1993); Guillermo

the relative power of the executive and legislature also affect the degree of raiding and the establishment of effective property rights institutions?

Differences on this variable across the four countries suggest it did not have any significant effect. Ukraine possesses the only purely presidential system among the four (with the exception of a brief interlude during the mid-2000s). This stands in contrast to Poland, with its semi-presidential system, and Slovakia and Estonia, which both have parliamentary regimes. That the latter three countries all lack powerful presidents appears to falsify the hypothesis that the degree of presidential power accounted for the different outcomes in this study.

The power of the legislature, too, does not line up with the observed outcomes. Fish and Kroenig painstakingly compiled a comprehensive index of parliamentary powers around the world.³³ Analyzing this index, Fish shows that the power of the parliament has a strong effect on the extent to which a country is democratic.³⁴ However, Estonia, Poland, and Slovakia all have virtually identical scores on the index while Ukraine's parliament rates considerably weaker than those of the others (Table 2.6). This does not square with this study's findings that Estonia and not Ukraine is the real outlier when it comes to raiding and property rights.

That said, if the index is broken down into its four component parts, one of the four dimensions – the influence of the legislature over the executive – does put Estonia slightly ahead of Poland and significantly above Slovakia and Ukraine. Thus, the potential role of strong legislative control over the executive branch cannot be ruled out. Nevertheless, if the Czech Republic does qualify as a case of high raiding (and we cannot conclusively say that it does due to a lack of adequate data), it would cast doubt on the importance of parliamentary influence on the executive; it scores the same as Estonia on this measure (Table 2.6).

Other scholars have drawn a distinction between unitary and federal arrangements. This refers to the division of powers between the national government and sub-national units. For example, Dewatripont & Roland argue that political decentralization (along with demonopolization) can compel banks and local governments to harden budget constraints on firms.³⁵ Shleifer & Vishny claim that the integrity of Poland's state institutions are superior to that of Russia's and attribute this fact to rules subjecting Polish local governments to elections and requirements to raise their own revenues.³⁶ The structure of local government in Ukraine is similar to that of Russia's in

O'Donnell, "Delegative Democracy," *Journal of Democracy* 5, no. 1 (1994); Matthew Soberg Shugart and John M. Carey, *Presidents and Assemblies: Constitutional Design and Electoral Dynamics* (New York: Cambridge, 1992); Fish, *Democracy Derailed in Russia: The Failure of Open Politics*; M. Steven Fish, "Stronger Legislatures, Stronger Democracies," *Journal of Democracy* 17, no. 1 (2006); Henry E. Hale, "Formal Constitutions in Informal Politics: Institutions and Democratization in Post-Soviet Eurasia," *World Politics* 63, no. 4 (2011).

³³ M. Steven Fish and Matthew Kroenig, *The Handbook of National Legislatures: A Global Survey* (New York: Cambridge, 2009). Data and codebook can be downloaded at <http://polisci.berkeley.edu/people/person/m-steven-fish>.

³⁴ Fish, *Democracy Derailed in Russia: The Failure of Open Politics*; Fish, "Stronger Legislatures, Stronger Democracies."

³⁵ Mathias Dewatripont and Gérard Roland, "Soft Budget Constraints, Transition, and Financial Systems," *Journal of Institutional and Theoretical Economics* 156, no. 1 (2000).

³⁶ Shleifer and Vishny, chapter 11.

Table 2.6. Parliamentary Powers

<u>Country</u>	<u>Parliamentary Powers Index</u>	<u>% Dif. from Estonia</u>
Bulgaria	0.78	3.0%
Czech Republic	0.81	6.0%
Estonia	0.75	0.0%
Poland	0.75	0.0%
Slovakia	0.72	-3.0%
Ukraine	0.59	-16.0%

<u>Country</u>	<u>Inflexec</u>	<u>% Dif. from Estonia</u>	<u>Instaut</u>	<u>% Dif. from Estonia</u>	<u>Specpow</u>	<u>% Dif. from Estonia</u>	<u>Instcap</u>	<u>% Dif. from Estonia</u>
Bulgaria	7	-10.0%	7	0.0%	7	22.2%	4	0.0%
Czech Republic	8	0.0%	7	0.0%	5	0.0%	6	28.6%
Estonia	8	0.0%	7	0.0%	5	0.0%	4	0.0%
Poland	7	-10.0%	6	-10.0%	5	0.0%	6	28.6%
Slovakia	6	-20.0%	7	0.0%	5	0.0%	5	14.3%
Ukraine	4	-40.0%	4	-30.0%	6	11.1%	5	14.3%

Parliamentary Powers Index: Scale: 0 to 1 (most powerful parliament)

Inflexec: Influence of the legislature over the executive. Scale: 0 to 9 (most powerful)

Instaut: Institutional autonomy of the legislature. Scale: 0 to 9 (most powerful)

Specpow: The number of "specified powers" the legislature possesses. Scale: 0 to 8 (most powerful)

Instcap: The institutional capacity of the legislature to perform its functions. Scale: 0 to 6 (most powerful)

Source: M. Steven Fish and Matthew Kroenig, *The Handbook of National Legislatures: A Global Survey* (New York: Cambridge, 2009). Data and codebook can be downloaded at <http://polisci.berkeley.edu/people/person/m-steven-fish>

this regard.³⁷ As we will see in the country chapters, however, local authorities in Poland are at least as rapacious and abusive towards businesses as are their counterparts in Ukraine. The evidence from the four countries suggests that the degree of centralization or decentralization had little impact, whether good or bad, on the dependent variables. Estonia, meanwhile, has the same level of state centralization as Ukraine.³⁸ Clearly, this hypothesis has little value in the cases under examination here (Table 2.7).

Gerring and Thacker themselves point to the combination of parliamentarism, unitarism, and an electoral law based on closed-list proportional representation as being the most favorable to the quality of democratic governance. In such “centripetal” arrangements, power flows inward to a single, accountable body. This contrasts with “centrifugal” designs, where power flows outward to multiple, competing units. A perfectly centrifugal system would consist of presidentialism, federalism, and a

³⁷ Charles Recknagel, “What Are Eastern Ukraine's (Legitimate) Grievances With Kyiv?” *Radio Free Europe/Radio Liberty*, 29 May 2014 (<http://www.rferl.org/content/ukraine-explainer-eastern-grievances/25402922.html>).

³⁸ See 2005 dataset compiled by John Gerring, Strom C. Thacker, and Carola Moreno at <http://www.bu.edu/sthacker/research/articles-and-data/>. Data was compiled for the following article: John Gerring, Strom C. Thacker, and Carola Moreno, "Centripetal Democratic Governance: A Theory and Global Inquiry," *American Political Science Review* 99, no. 4 (2005).

Table 2.7. Unitarism vs. Federalism and Degree of Centripetalism

<u>Variable</u>	<u>Country</u>	<u>Avg. Score (1991- 2001)</u>	<u>% Difference from Estonia</u>
Unitarism vs. Federalism	Estonia	2.00	
	Poland	1.50	-25.0%
	Slovakia	1.63	-18.5%
	Ukraine	2.00	0.0%
Centripetalism	Estonia	4.80	
	Poland	4.17	-12.6%
	Slovakia	5.59	15.8%
	Ukraine	3.30	-30.0%

Unitarism vs. Federalism: Scale: 0 (most federal) to 2 (most unitary). Data provided only up to 2001.

Centripetalism: Scale: 1 (least centripetal) to 6 (most centripetal). Data provided only up to 2001.

Source: John Gerring, Strom C. Thacker & Carola Moreno (2005), "Centripetal Democratic Governance: A Theory and Global Inquiry," *American Political Science Review* 99(4):567-81.

majoritarian electoral law.³⁹ If centripetal institutions increase the quality of democratic governance, they might similarly impact the strength of property rights institutions and the degree of raiding. Slovakia emerges as substantially more centripetal than Estonia, which would predict less raiding and stronger property rights institutions in the former, the opposite of what actually happened (Table 2.7).

Other accounts too emphasize the importance of institutions that foster greater elite accountability.⁴⁰ In its *Nations in Transit* series, Freedom House publishes a number of indicators going back to 1997 that collectively measure the degree of institutional accountability.⁴¹ The first is *electoral process*.⁴² Here, we see the same pattern that holds for many of the previous indicators. The average score for Estonia is only marginally different from those of Poland and Slovakia. Meanwhile, the scores of the latter two countries differ vastly from Ukraine's (Table 2.8).

³⁹ Ibid.

⁴⁰ ; Luigi Manzetti, "Political Manipulations and Market Reform Failures," *World Politics*, 55, pp 315-360 55, no. 3 (2003). Also see IBRD & The World Bank.

⁴¹ *Nations in Transit* was published in 1995 as well but included no quantitative measures of the variables to be considered in this section. No edition was published in 1996. The quantitative indicators only start in 1997. Data going back to 2003 can be found at <http://www.freedomhouse.org/report-types/nations-transit>. Data for all years can be found in Alexander Motyl Adrian Karatnycky, Amanda Schnetzer, *Nations in Transit: Civil Society, Democracy, and Markets in East Central Europe and the Newly Independent States* (New York and Washington: Freedom House, 2001); Ditmir Bushati, *Nations in Transit 2009: Democratization from Central Europe to Eurasia* (New York and Washington: Freedom House, 2009); Christopher Walker and Sylvana Habdank-Kołaczowska, *Fragile Frontier: Democracy's Growing Vulnerability in Central and Southeastern Europe* (New York and Washington: Freedom House, 2012).

⁴² Electoral Process "examines national executive and legislative elections, electoral processes, the development of multiparty systems, and popular participation in the political process." Prior to 2003 this indicator was termed "Political Process." See Walker and Habdank-Kołaczowska.

Table 2.8. Nations in Transit Indicators

<u>Variable</u>	<u>Country</u>	<u>Avg. Score (1997-2012)</u>	<u>% Difference from Estonia</u>
Electoral Process	Estonia	1.67	
	Poland	1.55	2.1%
	Slovakia	1.94	-4.4%
	Ukraine	3.59	-32.0%
National Democratic Governance	Estonia	2.25	
	Poland	2.41	-2.6%
	Slovakia	2.69	-7.3%
	Ukraine	4.91	-44.3%
Local Democratic Governance	Estonia	2.41	
	Poland	2.38	0.5%
	Slovakia	2.44	-0.5%
	Ukraine	5.31	-48.4%
Independent Media	Estonia	1.61	
	Poland	1.81	-3.4%
	Slovakia	2.61	-16.7%
	Ukraine	4.47	-47.7%

Variables are scaled from 1 (best) to 7 (worst)

Sources: Adrian Karatnycky, Alexander Motyl, Amanda Schnetzer, eds., Nations in Transit: Civil Society, Democracy, and Markets in East Central Europe and the Newly Independent States (New York and Washington: Freedom House, 2001); Ditmir Bushati, ed), Nations in Transit 2009: Democratization from Central Europe to Eurasia (New York and Washington: Freedom House, 2009); Christopher Walker & Sylvana Habdank-Kolaczowska, Fragile Frontier: Democracy's Growing Vulnerability in Central and Southeastern Europe (New York and Washington: Freedom House, 2012).

The same pattern obtains on another *Nations in Transit* indicator, *national democratic governance*.⁴³ Again, the differences between Estonia, Poland, and Slovakia are marginal yet Poland and Slovakia display huge differences from Ukraine. Beginning in 2005, *Nations in Transit* began scoring countries on *local democratic governance*, specifically.⁴⁴ The configuration of countries on this indicator is similar to that on the others; Estonia, Poland, and Slovakia are practically identical while the difference separating Ukraine from the rest is far too large (Table 2.8).

Many commentators have pointed to the role of another institutional variable, the independence of the media, in facilitating the emergence of effective institutions and limiting corruption.⁴⁵ *Nations in Transit* compiles an indicator which measures media

⁴³ This indicator measures “the democratic character and stability of the governmental system; the independence, effectiveness, and accountability of legislative and executive branches; and the democratic oversight of military and security services.” It continues from two earlier indicators, “governance and public administration” and, later, “democratic governance.” From 2005 onward it is listed under its current title. See *Nations in Transit*, various years.

⁴⁴ This indicator measures “the decentralization of power; the responsibilities, election, and capacity of local governmental bodies; and the transparency and accountability of local authorities.” See *Nations in Transit*, various years.

⁴⁵ See, for example, IBRD & the World Bank.

independence. It tells a different story than the others examined above.⁴⁶ On the one hand, the similar scores for Poland and Estonia suggest that the independence of the media did not impact the scale of non-plutocratic raiding, which is high in the former and low in the latter. On the other hand, these two countries score substantially better than Slovakia and Ukraine, thus raising the possibility that media independence can indeed account for the higher level of plutocratic raiding found in the latter two countries (Table 2.9).

In particular, perhaps a stronger and more independent media can prevent governments from overseeing massive amounts of siphoning on their watch. To be sure, even Poland's robust and independent media did not manage to constrain the level of informal soft budget constraints during the 1990s. These forms of asset stripping are easier to conceal from public view. But perhaps it did check the freedom of governments to get away with fraud in the largest and most visible privatizations. Had Slovakia possessed a more independent media, its governments – particularly the one led by the HZDS coalition from 1994 to 1998 – might have thought twice about overseeing such blatant privatization fraud in full public view. Likewise for Ukraine. As it happened, a fraudulent privatization process in Slovakia and Ukraine did contribute to the emergence of a powerful class of political thugs among both countries' plutocratic elites.

However, as later chapters will reveal, the primary reason why the Slovak and Ukrainian medias have proven relatively feeble is the persisting weakness of opposition political parties. The lack of robust party competition is what has allowed successive post-communist governments to impose restraints on media freedoms in the first place. Stronger parliamentary oppositions in these two countries might have succeeded in derailing efforts by various governments to place limits on media independence. The experience of Poland is also illustrative. Party competition there remained strong until the mid-2000s, when the widely-disparaged mainstream parties had lost all credibility with the electorate. This paved the way for an anti-establishment coalition to dominate Polish politics over the next few years, one which found itself free to start intervening in the country's media. As Grzymała-Busse argues, party competition may account for a number of features of democratic governance; "the role of NGOs, the judiciary, and the media may itself be endogenous to party competition and state support."⁴⁷

That said, while media restrictions might enhance the government's ability to get away with privatization fraud, they are by no means required. This is made evident by the experience of the Czech Republic. Its privatization process was marked by large-scale corruption⁴⁸ and yet the media remained free throughout it. According to *Nations in Transit*, the independence of the Czech media from 1997 to 2009 was only six percent below that of Estonia (although restrictions increased from 2010 onward).⁴⁹ What did distinguish the Czech Republic was the longstanding domination of the Civic Democratic

⁴⁶ Nations in Transit compiles an indicator measuring the independence of the media. In particular, the indicator is designed to reflect "the current state of press freedom, including libel laws, harassment of journalists, and editorial independence; the emergence of a financially viable private press; and internet access for private citizens." See *Nations in Transit*, various years.

⁴⁷ Grzymała-Busse, 49.

⁴⁸ H. Appel, "Corruption and the Collapse of the Czech Transition Miracle," *East European Politics & Societies* 15, no. 3 (2001).

⁴⁹ See Freedom House, *Nations in Transit*, various years.

Table 2.9. Media Independence, 1997-2012

Country	1997	1998	1999	2000	2001	2002	2003	2004	2005
Estonia	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.5	1.5
Poland	1.5	1.5	1.5	1.5	1.5	1.5	1.75	1.75	1.5
% Difference from Estonia	4.2%	4.2%	4.2%	4.2%	4.2%	4.2%	0.0%	-4.2%	0.0%
Slovakia	4.25	4	2.25	2.25	2	2	2	2.25	2.25
% Difference from Estonia	-41.7%	-37.5%	-8.3%	-8.3%	-4.2%	-4.2%	-4.2%	-12.5%	-12.5%
Ukraine	4.5	4.75	5	5	5.25	5.5	5.5	5.5	4.75
% Difference from Estonia	-45.8%	-50.0%	-54.2%	-54.2%	-58.3%	-62.5%	-62.5%	-66.7%	-54.2%

Country	2006	2007	2008	2009	2010	2011	2012	Avg.
Estonia	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.61
Poland	1.75	2.25	2.25	2	2.25	2.25	2.25	1.81
% Difference from Estonia	-4.2%	-12.5%	-12.5%	-8.3%	-12.5%	-12.5%	-12.5%	-3.4%
Slovakia	2.25	2.25	2.5	2.75	3	3	2.75	2.61
% Difference from Estonia	-12.5%	-12.5%	-16.7%	-20.8%	-25.0%	-25.0%	-20.8%	-16.7%
Ukraine	3.75	3.75	3.5	3.5	3.5	3.75	4	4.47
% Difference from Estonia	-37.5%	-37.5%	-33.3%	-33.3%	-33.3%	-37.5%	-41.7%	-47.7%

Red signifies a difference from Estonia of greater than 10%
Variable scaled from 1 (best) to 7 (worst)

Sources: Adrian Karatnycky, Alexander Motyl, Amanda Schnetzer, eds., Nations in Transit: Civil Society, Democracy, and Markets in East Central Europe and the Newly Independent States (New York and Washington: Freedom House, 2001). Dittmir Bushati, ed., Nations in Transit 2009: Democratization from Central Europe to Eurasia (New York and Washington: Freedom House, 2009). Christopher Walker & Sylvana Habdank-Kolaczowska, Fragile Frontier: Democracy's Growing Vulnerability in Central and Southeastern Europe (New York and Washington: Freedom House, 2012).

Party, which led a government that was insufficiently restrained by the parliamentary opposition.⁵⁰

With the exception of media independence, most of the *Nations in Transit* indicators exhibit little difference among Poland, Estonia, and Slovakia. But this is only true *on average*. If one examines these phenomena during a brief but critical period in the mid-1990s, Slovakia scored substantially worse than both Poland and Estonia. This occurred during the HZDS government led by Vladimir Mečiar. Under the last two years of HZDS rule (1997 and 1998), Slovakia came out 25 percent worse than Estonia in terms of the quality of its electoral process, 27 percent worse on media independence, and 21 percent worse with regard to national democratic governance.⁵¹

Moreover, from 1996 to 1998 Slovakia scored 17 percent worse than Estonia on the World Bank's *regulatory quality* measure. Meanwhile, Freedom House marked Slovakia as "partially free" in 1996-97, similarly to Ukraine and in contrast to Estonia and Poland, which were both ranked "free." Finally, although Slovakia was formally a

⁵⁰ Grzymała-Busse, 73-76.

⁵¹ The actual names for some of these variables differed during this period. "Electoral process" was labeled as "political and electoral process" while "national democratic governance" was referred to as "governance and public administration." See *Nations in Transit*, various years.

parliamentary regime throughout the post-communist period, under the HZDS it certainly did not seem to function in this manner. In particular, while the country lacked a constitutionally strong president, its political institutions at the time fell under the informal domination of an executive branch controlled by the HZDS coalition.⁵²

What this all added up to was a fundamental lack of institutional accountability on the prerogatives of the Mečiar government. However, as with media independence in this period, the overall absence of institutional accountability in Slovakia was itself the result of the lack of strong party competition. The political dominance of the HZDS-led coalition granted the government free reign to trample upon whatever institutional constraints existed at the time. It is not like the legislature wanted to impose checks on the government but failed due to the absence of robust institutional limits on the government's actions. Mečiar and his cronies enjoyed the full support of a pliant parliamentary majority until the government's downfall in 1998. It was precisely the dominance of the coalition majority vis-à-vis the opposition that enabled Mečiar to sidestep these institutional constraints.

Another factor that might explain the differences in the degree of raiding and the strength of property rights institutions is "state capture" (Table 2.10). This refers to informal payments by firms to influence the content of laws, rules, and decrees.⁵³ An environment highly conducive to such influence would certainly create opportunities for raiders to craft the rules in a way that maximizes their capacity to take over other firms. In their *Business Environment and Enterprise Survey*, the EBRD and World Bank asked companies in the region how often "firms like yours" make such illicit payments (1 = never, 6 = always). In the 1999 survey, the average response for each of the four countries ranged between 5.5 and 5.8, whereas in the 2005 survey (the last one in which this question was asked) the country averages fell to between 1.2 and 1.4. This dramatic drop, while interesting in its own right, is for the purpose of this study irrelevant; in both years there was very little variation among the four countries. The degree of state capture, then, cannot explain the large differences on the dependent variables.

Another institutional variable often cited as influencing the property rights environment is the extent of disorganized regulation. A growing number of scholars have noted the role disorganized regulation can play in encouraging corruption and forcing firms into the informal economy, thereby making them vulnerable to protection rackets.⁵⁴ It might also create a more conducive environment for criminal corporate raiding. Complex and mutually-contradictory regulations create opportunities for raiders to bring down the power of the state on their targets. After all, the more complex and contradictory regulations are, the more likely that any given firm is in violation of at least one of them.

The World Bank has recently shed light on this problem by compiling rankings of countries in terms of the ease of doing business (Table 2.11). The variations that emerge are stark. Estonia places well ahead of Poland and Slovakia, which in turn are ranked far

⁵² M. Steven Fish, "The Dynamics of Democratic Erosion," in *Postcommunism and the Theory of Democracy*, ed. Richard D. Anderson et al. (Princeton: Princeton, 2001), 77-78.

⁵³ Fries et al; Gray et al; Hellman et al; Hellman et al; Hellman and Schankerman.

⁵⁴ IBRD & The World Bank; Phyllis Dininio and Robert W. Orttung, "Explaining Patterns of Corruption in the Russian Regions," *World Politics* 57, no. 4 (2005); Frye, "Private Protection in Russia and Poland."; Frye and Zhuravskaya, "Rackets, Regulation, and the Rule of Law."

Table 2.10. State Capture

<u>Country</u>	<u>1999 Score</u>	<u>% Difference from Estonia</u>	<u>2005 Score</u>	<u>% Difference from Estonia</u>
Estonia	5.78		1.35	
Poland	5.67	2.2%	1.41	-1.1%
Slovakia	5.64	2.9%	1.23	2.4%
Ukraine	5.54	4.8%	1.24	2.2%

*Scale: 1 (lowest state capture) to 6 (highest state capture)

Source: EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS). Data available at <http://data.worldbank.org/data-catalog/BEEPS>.

higher than Ukraine. This is the only quantitative variable (out of 26) on which Estonia emerges at least 10 percent better than all three of the other countries. This suggests that the ease of doing business may very well account for why Estonia's property rights institutions are far more robust than those of the others.

To the extent that it does play a role, a system of disorganized regulation does not simply appear out of nowhere. It is deliberately put in place by the powerful in order to facilitate opportunities for corruption, extortion, and expropriation.⁵⁵ Precisely who these actors are and what their agenda is becomes highly consequential for the complexity and ambiguity of the regulatory rules they adopt. Governments headed by corrupt leaders or under the thumb of dishonest businesspeople would be expected to put such arrangements into place; disorganized regulations would greatly enhance their ability to raid and extract rents from others. This illustrates the importance of examining how powerful actors shape institutions rather than only analyzing the impact of institutions on actors, as is the conventional approach.

There remains the question of whether differences in the effectiveness of property rights institutions *caused* the observed variations in raiding. This is exactly what much of the property rights literature discussed in the previous chapter would expect. Did Estonia manage to create such institutions just in time to prevent raiding from spiraling out of control? This is unlikely. In the other three countries, examples of raiding became common from the very beginning of the post-communist period. Unless robust, efficient property rights institutions happened to sprout practically overnight in Estonia, and the chapter on Estonia will show that they did not, they could not possibly account for the lack of raiding there.

Indeed, Estonia's property rights institutions remained disorganized and insufficiently developed during most of the 1990s. And yet it experienced no raiding on any significant scale during this period. This contrasts sharply with the experiences of the other three countries. There must exist some other set of factors besides the strength of a country's property rights institutions that can account for the variations in raiding during the first post-communist decade.

This conclusion challenges the current orthodoxy that property rights abuses are the effect of weak property rights institutions. A central finding of this study is that *both*

⁵⁵ Albats.

Table 2.11. Ease of Doing Business

Country	Rank (1-185)	% Difference from Estonia
Estonia	20.0	
Poland	64.5	-24.1%
Slovakia	46.0	-14.1%
Ukraine	144.5	-67.3%

Score represent's the average of a country's overall rank (out of 185) for 2012 and 2013 (the only years for which the rankings have appeared thus far).

Source: *Doing Business, The World Bank* (<http://www.doingbusiness.org>).

property rights abuses *and* weak property rights institutions were instead the result of the kinds of actors that predominated in the state and economy. When the wrong actors amass too much power, they will use and abuse any institutions at their disposal – especially during periods of major institutional flux and change such as that which characterized the first post-communist decade. Once such actors become entrenched, property rights institutions are bound to remain enfeebled under the weight of political thugs, crony capitalists, corrupt state officials, and crooked politicians. In the countries examined here, only the rise of revolutionary governments that quickly imposed hard budget constraints upon firms proved able to stem the rise to power of such actors. It was the marginalization of these actors that would create a firm foundation in which property rights institutions could actually take root.

Miscellaneous Explanations

If most policy-centric and institutionalist variables fail to explain the variant outcomes in this study, a number of alternative hypotheses remain that must be considered. These include the dependence of the economy on natural resource rents, the level of economic development, the degree of economic inequality, the density of social capital, the strength of civil society, and the presence or absence of a Protestant tradition. Each of these will be examined in turn.

There by now exists longstanding evidence that a higher endowment of natural resources can, under certain conditions, at least, lead to dictatorship, economic underdevelopment, institutional decay, and pervasive corruption.⁵⁶ But this cannot account for the scale of raiding and the strength of property rights institutions in the four countries examined here. All display a roughly equal – and low – reliance on natural resource extraction. The World Bank publishes an annual indicator of resource rents as a percentage of GDP. For all years on which data is available, Estonia averages 1.2 percent of GDP, Poland 1.0 percent, and Slovakia 0.4 percent. Ukraine's is slightly higher at 3.6

⁵⁶ Karl; Chaudhry; Weinthal and Luong, "Energy Wealth and Tax Reform in Russia and Kazakhstan."; Ross, "Does Oil Hinder Democracy?"; Fish, *Democracy Derailed in Russia: The Failure of Open Politics*.

percent but remains far below many of the world's most resource-dependent economies, which tend to score at well above 20 percent of GDP.⁵⁷

Another widely cited predictor of democratization and corruption is a country's level of economic development.⁵⁸ This variable too fails to explain the variations observed in this study. As late as 2011, Estonia's GDP per capita continued to lag that of Slovakia's. It was lower than Poland's until 2002 – too late to have had any subsequent effect on the level of raiding or the robustness of property rights institutions. In this study, at least, the level of economic development does not work as an explanatory factor (Table 2.12).

Others have pointed to high income inequality as a cause of weak property rights institutions. Glaeser et al. propose that in highly unequal societies the rich find it easier to subvert existing institutions and extract rents from others. Meanwhile the have-nots are compelled to expropriate wealth from the haves through either the political process or violence. Both of these methods of wealth redistribution undermine the effectiveness of property rights institutions.⁵⁹ This explanation too fails to hold in the four countries. Average annual Gini scores for all post-communist years reveals that Estonia has higher income inequality than the other three countries.⁶⁰ Clearly, income inequality did not have the predicted effect.

The density of social capital and the strength of civil society similarly fail as explanations. Turning first to social capital, the *World Values Survey* asks respondents, "generally speaking, would you say that most people can be trusted or that you need to be very careful in dealing with people?" As of the mid-1990s, when this factor would have necessarily begun to play a role in affecting raiding and property rights institutions, Estonians displayed less faith and more caution in trusting others than did Slovaks or Ukrainians. Social capital, at least as measured by the prevailing level of trust within a society, does not give us the valid predictor we need.⁶¹

⁵⁷ *The Changing Wealth of Nations: Measuring Sustainable Development for the New Millennium* (Washington: The World Bank, 2011). The data is available at <http://data.worldbank.org/indicator/NY.GDP.TOTL.RT.ZS>.

⁵⁸ Dininio & Orttung cite economic development in explaining regional variations in the level of corruption within Russia. Dininio and Orttung, "Explaining Patterns of Corruption in the Russian Regions." Also see Evelyne Huber, Dietrich Rueschemeyer, and John D. Stephens, "The Impact of Economic Development on Democracy," *Journal of Economic Perspectives* 7, no. 3 (1993); Janos, *East Central Europe in the Modern World: The Small States of the Borderlands from Pre- to Postcommunism*; Seymour Martin Lipset, *Political Man: The Social Bases of Politics* (Garden City, NY: Doubleday, 1960).

⁵⁹ Glaeser et al., "The Injustice of Inequality."

⁶⁰ High Gini scores indicate higher inequality. Estonia's average score through 2011 is 36.2, compared to 33.2 for Poland, 29.5 for Ukraine, and 26.6 for Slovakia. See World Bank data at <http://data.worldbank.org/indicator/SI.POV.GINI>.

⁶¹ See *World Values Survey* (<http://www.worldvaluessurvey.org/wvs.jsp>). While 28.8% of Ukrainians (1996) and 25.8% of Slovaks (1998) believed that most people can be trusted, only 21.1% of Estonians (1996) answered similarly. Meanwhile, 76.8% of Estonians insisted that one "can't be too careful" when it comes to trusting others. This contrasts with figures of 69.5% and 64.1% of Slovaks and Ukrainians, respectively. Poles (1997) display the least trust in others; 16.9% believe most people can be trusted while 77.5% believe that one cannot be too careful. (Note: the reason why the dates listed above are not the same is that the World Values Survey is not always administered in the same countries in the same year. I selected the particular years above, first, because the only number for Estonia appeared in the 1996 survey and, second, since the dates for the other countries offered the closest possible comparisons to Estonia and each another during the early transition era.

Table 2.12. Level of Economic Development Over Time (GDP per capita, current US\$)

Country	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Estonia							\$2,629	\$3,340	\$3,610	\$4,036	\$4,150
Poland	\$2,166	\$1,694	\$2,187	\$2,406	\$2,443	\$2,813	\$3,603	\$4,057	\$4,066	\$4,472	\$4,340
Slovakia	\$1,852	\$2,211	\$2,474	\$2,690	\$3,032	\$3,686	\$4,710	\$5,078	\$5,023	\$5,431	\$5,550
Ukraine	\$1,597	\$1,570	\$1,490	\$1,418	\$1,258	\$1,012	\$936	\$873	\$991	\$835	\$636

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Estonia	\$4,144	\$4,573	\$5,386	\$7,270	\$8,913	\$10,330	\$12,503	\$16,393	\$17,739	\$14,264	\$14,062	\$16,533
Poland	\$4,454	\$4,979	\$5,184	\$5,675	\$6,620	\$7,963	\$8,958	\$11,157	\$13,886	\$11,294	\$12,303	\$13,463
Slovakia	\$5,330	\$5,637	\$6,439	\$8,521	\$10,418	\$11,385	\$12,799	\$15,583	\$18,109	\$16,100	\$16,036	\$17,646
Ukraine	\$636	\$781	\$879	\$1,049	\$1,367	\$1,829	\$2,303	\$3,069	\$3,891	\$2,545	\$2,974	\$3,615

Source: World Development Indicators, The World Bank (<http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>)

A vibrant civil society is another possible factor that can potentially limit the scale of raiding and promote the development of property rights institutions. Where societal organizations are numerous, autonomous from the state, and highly active, they might hold in check the corrupt business and political actors responsible for property rights abuses.⁶² *Nations in Transit* scores the various post-communist countries on this variable (Table 2.13).⁶³ Estonia's average score from 1997 to 2012 is actually lower than that of Poland and Slovakia. Furthermore, the difference between the latter two countries and Ukraine is quite large and so cannot explain the similarities between them on the dependent variables. To be sure, Slovakia's ratings during the Mečiar era, like Ukraine's, were considerably worse than those of both Estonia and Poland. This might account for the different levels of plutocratic raiding among the two sets of countries.⁶⁴ However, if Slovakia had a weak civil society in this period it was because the ruling HZDS-led coalition was sufficiently dominant over other parties to beat it down. Likewise, Ukraine's weak and fractured opposition was far too weak to serve as the defender of the country's nascent civil society. To the extent that a weak civil society played a role at all, it was the effect of weak party competition.

Last but certainly not least is the degree to which a given country has a longstanding Protestant tradition. Since Weber first articulated his famous thesis,⁶⁵ scholars have linked the presence of a strong Protestant heritage to a variety of outcomes.

⁶² See, for example, Leonid Polishchuk, "Misuse of Institutions: Lessons from Transition," in *Economies in Transition: The Long-Run View*, ed. Gérard Roland (New York: Palgrave Macmillan, 2012). Taylor also incorporates the role of civil society into his explanation of why Putin's state-building policies have at best met with mixed success and often failed. The regime's repression of civil society undermined the very organizations that might hold state officials accountable for their actions and prevent corruption. See Brian Taylor, *State Building in Putin's Russia: Policing and Coercion after Communism* (New York: Cambridge, 2011).

⁶³ The "civil society" indicator assesses "the growth of nongovernmental organizations (NGOs), their organizational capacity and financial sustainability, and the legal and political environment in which they function; the development of free trade unions; and interest group participation in the policy process." See Freedom House, *Nations in Transit*, various years.

⁶⁴ In 1997-98, Slovakia's average score was 15% worse than Estonia's and 31% worse than Poland's, while Ukraine's average score during this period was 31% worse than Estonia's and 48% worse than Poland's.

⁶⁵ Max Weber, *The Protestant Ethic and the Spirit of Capitalism* (New York: Routledge, 2013 [1930]).

Table 2.13. Strength of Civil Society

Country	1997	1998	1999	2000	2001	2002	2003	2004
Estonia	2.25	2.25	2.50	2.50	2.25	2.00	2.00	2.00
Poland	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
Slovakia	3.25	3.00	2.25	2.25	2.00	1.75	1.50	1.25
Ukraine	4.00	4.25	4.00	4.00	3.75	3.75	3.50	3.75

Country	2005	2006	2007	2008	2009	2010	2011	2012	Average	% Difference from Estonia
Estonia	2.00	2.00	2.00	1.75	1.75	1.75	1.75	1.75	2.03	
Poland	1.25	1.25	1.50	1.25	1.50	1.50	1.50	1.50	1.33	11.7%
Slovakia	1.25	1.25	1.50	1.50	1.75	1.75	1.75	1.75	1.86	2.9%
Ukraine	3.00	2.75	2.75	2.75	2.75	2.75	2.75	2.75	3.33	-21.6%

Scale: 1 (strongest civil society) to 7 (weakest)

Sources: Karatnycky, Motyl & Schnitzer, eds. (2001); Bushati, ed. (2009); Walker & Habdank-Kolaczowska (2012).

Most relevant to this study is the finding, based on numerous cross-national statistical analyses, of an inverse relationship between Protestantism and corruption.⁶⁶

There remains a debate over whether the key variable is the percentage of current Protestant adherents or a strong historical Protestant tradition.⁶⁷ The former clearly does not work in the four countries; according to the *World Values Survey*, as of 1996 only 10 percent of Estonians identified themselves as Protestant while the most prevalent affiliation in Estonia at the time was Orthodox Christianity (16 percent), due to the large Russian-speaking population residing there.⁶⁸

Regardless of the low number of current adherents, Estonia is still the only country among the four with a strong *historical tradition* of Protestantism. Lutheranism spread quickly in Estonia after its introduction there in 1524.⁶⁹ In the 1934 census, Lutheranism claimed adherents among 78 percent of Estonian citizens. Might its Protestant heritage have somehow ended up restraining the rapaciousness of the powerful in the post-communist era? To the extent that it did, it had to operate through one or more additional causal mechanisms that ultimately generated this outcome. After all, one could not possibly expect there to exist a direct relationship between the percentage of Protestants 100 years ago and political outcomes today.

What causal mechanisms has the literature offered up to link historical phenomena from long ago to current political outcomes? And to what extent is the distribution of these intervening variables across the four countries consistent with the

⁶⁶ John Gerring and Strom C. Thacker, "Political Institutions and Corruption: The Role of Unitarism And. Parliamentarism," *British Journal of Political Science* 34, (2004); Daniel Treisman, "The Causes of Corruption: A Cross-National Study," *Journal of Public Economics* 76, no. 3 (2000).

⁶⁷ Omer Gokekus, "Is It Protestant Tradition or Current Protestant Population That Affects Corruption?," *Economics Letters* 99 (2008) 99, (2008).

⁶⁸ See *World Values Survey* (<http://www.worldvaluessurvey.org/wvs.jsp>)

⁶⁹ J. Gordon Melton, *Encyclopedia of Protestantism* (New York: Checkmark Books), 209; Kevin C. O'Connor, *The History of the Baltic States* (Westport, CT: Greenwood, 2003), 104.

observed outcomes? Treisman finds evidence that Protestantism reduces corruption by facilitating economic growth and promoting a strong democracy.⁷⁰ This does not appear to hold in the four countries examined here. The average growth rates for Estonia, Poland, and Slovakia between 1994 to 2012 are nearly identical while the difference between these three countries and Ukraine is vast.⁷¹ The earlier discussion of the strength of democracy reveals a similar pattern.

Even after controlling for these two variables, Treisman still finds that Protestantism has an additional impact not accounted for by democracy and economic growth. He proposes a number of other causal mechanisms that might account for this. First, by separating church from state, a Protestant tradition creates a precedent and tolerance for a strong civil society that is itself independent from the state. However, as demonstrated above, the vibrancy of civil society cannot explain the different outcomes across the four countries.

A second reason why Protestantism might limit corruption is its “greater tolerance for challenges to authority and for individual dissent, even when threatening to social hierarchies.” This “renders Protestant societies more likely to discover and punish official abuses.”⁷² This hypothesis can be tested by relying on responses to four questions in the *World Values Survey* that indicate how readily one would engage in actions that challenge authority. I compiled a *Rebelliousness Index* based on these responses for Estonia, Poland, Ukraine, and Slovakia. The first three questions ask about one’s propensity to participate in boycotts (Question EO26), attend peaceful demonstrations (EO27), and join unofficial strikes (EO28). The fourth asks whether even the “least liked group” in society “should be allowed to...hold public demonstrations (E195).”⁷³ In addition to the *Rebelliousness Index*, I used the negative answers to the four questions to construct an alternative *Obedience Index* (Table 2.14). The index score for the *Rebelliousness Index* represents the average percentage of respondents indicating they “have done” or “might do” activities relating to protest along with those answering “yes” to the question of whether the least liked group should be able to demonstrate. The score for the *Obedience Index* is the average percentage indicating that they “would never do” such activities along with those answering “no” to the question of whether the least liked group can demonstrate.

These indices were not compiled by cherry-picking those indicators that happened to be consistent with the conclusions of this study; I chose all questions from the *World Values Survey* that seemed to have any connection to rebelliousness and obedience and for which data was available on all four countries. To my knowledge, there are no other

⁷⁰ Treisman, "The Causes of Corruption: A Cross-National Study," 427.

⁷¹ According to IMF figures, the average annual percent change in real GDP was 4.6% for Estonia, 4.4% for Poland, and 4.5% for Slovakia. This compares to 0.4% for Ukraine. Data is available at <http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx>.

⁷² Treisman, "The Causes of Corruption: A Cross-National Study," 427.

⁷³ The possible responses were that one has “actually done any of these things, whether [one] might do it or would never, under any circumstances, do it.” To construct the index for a given country, I took the total percentage that said that they either “have done” or “might do” each of the first three activities along with the percentage agreeing that the least liked group in society should be able to demonstrate. I then multiplied the each of the resulting four figures by 0.25. The country’s index score was then constructed by adding the four figures together. For Estonia I used the 1996 survey (the only one available), for Poland the 1997 survey, for Slovakia the 1998 survey, and for Ukraine the 1996 survey.

Table 2.14. Rebelliousness and Obedience Indices

	<u>EO26: Joining in Boycotts?</u>		<u>EO27: Attending Demonstrations?</u>		<u>EO28: Unofficial Strikes?</u>	
	Have Done/ Might Do	Would Never Do	Have Done/ Might Do	Would Never Do	Have Done/ Might Do	Would Never Do
Estonia	34%	61%	59%	38%	21%	74%
Poland	26%	66%	41%	52%	17%	74%
Slovakia	47%	41%	51%	40%	26%	61%
Ukraine	20%	67%	47%	43%	11%	76%

	<u>Rebelliousness Index</u>	<u>Obedience Index</u>
Estonia	30%	66%
Poland	24%	67%
Slovakia	32%	56%
Ukraine	21%	66%

Source: World Values Survey (<http://www.worldvaluessurvey.org/wvs.jsp>)

indicators that specifically measure cultural norms around challenging authority. There are measures of violent unrest as well as political stability.⁷⁴ But these phenomena are hardly coterminous with a cultural proclivity toward dissent.

If a Protestant tradition or lack thereof truly affected the willingness of citizens to challenge authority, Estonia's score on the Rebelliousness Index should be uniquely high compared to the other three countries. Estonia does indeed emerge with a higher score than either Poland or Ukraine. But it is Catholic Slovakia rather than Protestant Estonia that stands above the rest. Slovakia similarly ranks much lower on the obedience index than do the other three countries. If a Protestant tradition creates a greater proclivity for challenging authority in the rest of the world, it does not appear to have had any similar impact in the four countries examined here.

Citing an earlier study by Lipset and Lenz,⁷⁵ Treisman identifies a final mechanism by which Protestantism might reduce corruption. Lipset and Lenz contend that "Protestants, particularly sectarians, believe that individuals are personally responsible for avoiding sin, while other Christian denominations, particularly the Catholic church, place more emphasis on the inherent weakness of human beings, their inability to escape sin and error, and the need for the church to be forgiving and

⁷⁴ See Monty G. Marshall, "Major Episodes of Political Violence, 1946-2013." Available at <http://www.systemicpeace.org/warlist.htm>. The World Bank compiles an indicator of "Political Stability and Absence of Violence" in its Worldwide Governance Indicators Dataset. Data is available at www.govindicators.org.

⁷⁵ S.M. Lipset and G.S. Lenz, "Corruption, Culture and Markets," (Fairfax, VA: George Mason University, 1999).

protecting.” To the extent that these values merely represent the actual religious beliefs of practicing Protestants, they cannot explain the outcomes in Estonia as the country has relatively few such adherents remaining today (as we have already seen). To the extent that they left a lasting imprint on secular Estonian culture, they may very well account for Estonian exceptionalism, although it would be hard to pin down. If they did, however, the imprint would have had to have been made before the advent of Soviet rule, which went to great lengths to stamp out the teaching of religion.

Lipset and Lenz raise another possibility, arguing that Protestantism reduces corruption by cultivating individualistic values among the members of society. To assess this hypothesis, they compile a cross-national “Familism Scale” based on questions from the *World Values Survey*. The survey asks respondents if they agree that, “regardless of the qualities and faults of one’s parents, a person must always love and respect them” and that “divorce is unjustifiable.” Lipset and Lenz add to these a World Bank indicator on the mean number of births per woman. They indeed find a negative correlation between Protestantism and familism and conclude that “Protestantism reduces corruption, in part, because of its association with individualistic, non-familistic relations.”⁷⁶ Applied to the four countries here, the relationship does not hold up. Estonia’s score on the Familism Index is about the same as those of Ukraine and Slovakia and lower than Poland’s (Table 2.15).

In sum, most of the causal mechanisms by which a Protestant tradition could have affected the outcomes in Estonia do not hold water. However, there are some that are impossible to rule out – particularly the possibility that Protestantism left a secular cultural imprint making Estonians less tolerant of official abuses and an alternative possibility that it rendered the pre-independence state bureaucracy less prone toward corruption. To the extent that it played a role, however, it likely did so only by facilitating the rise to power of a post-communist government committed to hard budget constraints. And the particular reasons behind that government’s rise to power is beyond the scope of this investigation.

Conclusion

This chapter has considered a wide range of independent variables identified in the literature on post-communist Eurasia as well as other regions of the world. It has assessed how well these different factors account for the variant outcomes in the extent of plutocratic raiding and non-plutocratic raiding along with the robustness of legal property rights institutions. We must acknowledge that a handful of possible explanations, such as the influence of the legislature over the executive and Protestantism’s intolerance for sin, cannot be ruled out. The vast majority, however, can be excluded. Many of them fail to meet the requirement of a minimum 10-percent difference in the scores attained by the various countries. Others, such as media independence, pass this threshold but are actually the effects of the actor-centered variables highlighted in this study. Specifically, a number of independent variables display differences of 10 percent or more between Slovakia in the mid-1990s and Ukraine, on the one hand, and Poland and Estonia, on the

⁷⁶ Seymour Martin Lipset and Gabriel Salman Lenz, “Corruption, Culture, and Markets,” in *Culture Matters : How Values Shape Human Progress*, ed. Samuel P. Huntington and Lawrence E. Harrison (New York: Basic Books, 2000). Quotation is from p. 120.

Table 2.15. Familism Index

	<u>Respect for Parents - Always?</u>	<u>Divorce- Never Justifiable?</u>	<u>Births Per Woman</u>	<u>Familism Scale</u>
Estonia (1996)	0.81	0.07	0.11	0.33
Poland (1997)	0.92	0.25	0.11	0.42
Slovakia (1995)	0.85	0.09	0.11	0.34
Ukraine (1996)	0.87	0.15	0.08	0.36

Births per woman score was calculated by rescaling from the original data to a 0-1 scale, using the lowest and highest scores of all countries as the minimum and maximum values, respectively (Italy = 1.26, Yemen = 8.66)

Sources: *World Values Surveys (1995-1998)*; *The World Bank, World Development Indicators* (<http://data.worldbank.org/indicator/SP.DYN.TFRT.IN>)

other. However, these differences were the result of the lack of strong party competition in the former two cases, a factor that will play a prominent role in chapters to come. The next chapter, in particular, will discuss how the strength of party competition along with other actor-centered variables set in motion a causal process that ultimately set the four countries on very different trajectories.

Chapter Three

The Causal Framework

The introductory chapter presented the causal framework in its most basic form. The aim was to render the argument sufficiently generalizable to any historical instance of early capitalism. Nevertheless, each such historical instance necessarily involves its own particularities that distinguish it from other countries and regions at different points in time. The post-communist moment is one such example. This chapter will show the specific way in which the general causal framework unfolded in the four post-communist countries that form the basis of this study. It will also explain how each of the variables will be measured.

The best way to present the different variables and their particular consequences may be to work backwards in analytical time from the capitalist-competition stage through the stage of capital accumulation and finally to the elite-ascendance stage. The dependent variables are situated at the capitalist competition stage. To review the distribution of cases on the dependent variables, Ukraine and Slovakia exhibit abundant raiding among both the plutocratic and non-plutocratic elites; Poland displays little raiding among the plutocratic stratum yet widespread raiding among the non-plutocratic elite; and Estonia is marked by little raiding among both elite groups. In terms of property rights institutions, Estonia stands alone among the four countries.

The causal story presented below is notable for the general absence of international factors. This is not to say that they were irrelevant. As the country chapters will show, external actors appear again and again in varying roles: Gazprom, Vladimir Putin, Russian banks and firms, security officials and political thugs from other neighboring countries, West European banks and firms, German privatization advisers, the European Union, the OECD, Transparency International, Freedom House, Reporters Without Borders, the United Nations, and international arbitration courts, among others, will all show up in some form or another in the case studies.

Of particular importance are offshore secrecy jurisdictions and tax havens. This system allows wealthy elites, including but not limited to political thugs, to stash their assets safely out of reach from their home governments. As a consequence, it boosts the level of unaccountability that elites enjoy from domestic institutions while depriving these institutions of the resources they need to counter the influence of criminal business actors.¹ The concluding chapter of the dissertation will consider the role of offshore havens in greater depth.

¹ Nicholas Shaxson, *Treasure Islands: Uncovering the Damage of Offshore Banking and Tax Havens* (New York: Palgrave Macmillan, 2012); Raymond Baker, *The Blood Bankers*; Baker, *Capitalism's Achilles Heel* (Hoboken, NJ: John Wiley & Sons); James S. Henry, *The Blood Bankers: Tales from the Global Underground Economy* (New York: Four Walls Eight Windows, 2003); *Undue Diligence: How Banks Do*

Some of the external forces noted above exerted positive – or potentially positive – influences in terms of reducing economic criminality and improving property rights protections. Others had negative effects. What unites them is their relatively equal impact across all four countries. Thus, to the extent that they did affect the outcomes under consideration, they could not have been decisive. The EU did influence the countries unequally; Estonia, Poland, Slovakia became members in 2004 while Ukraine remains a non-member. But, as the previous chapter stressed, even accession to the EU could not account for differences on the dependent variables.

By implication, then, we must necessarily turn to domestic factors to explain these differences. This chapter will detail what these factors were. The lesson that emerges is that students of political economy cannot restrict themselves to only analyzing the ways that institutions shape actors; we must also understand the various means by which actors shape institutions.

Capital Accumulation

The following sections will detail the explanatory variables that account for the differences in raiding and property rights institutions. It will also describe their relationships to another along with how each variable will be measured. The dependent variables, which operate at the stage of capitalist competition, were examined in the Chapter One. We thus begin with the variables at the second stage, that of capital accumulation.

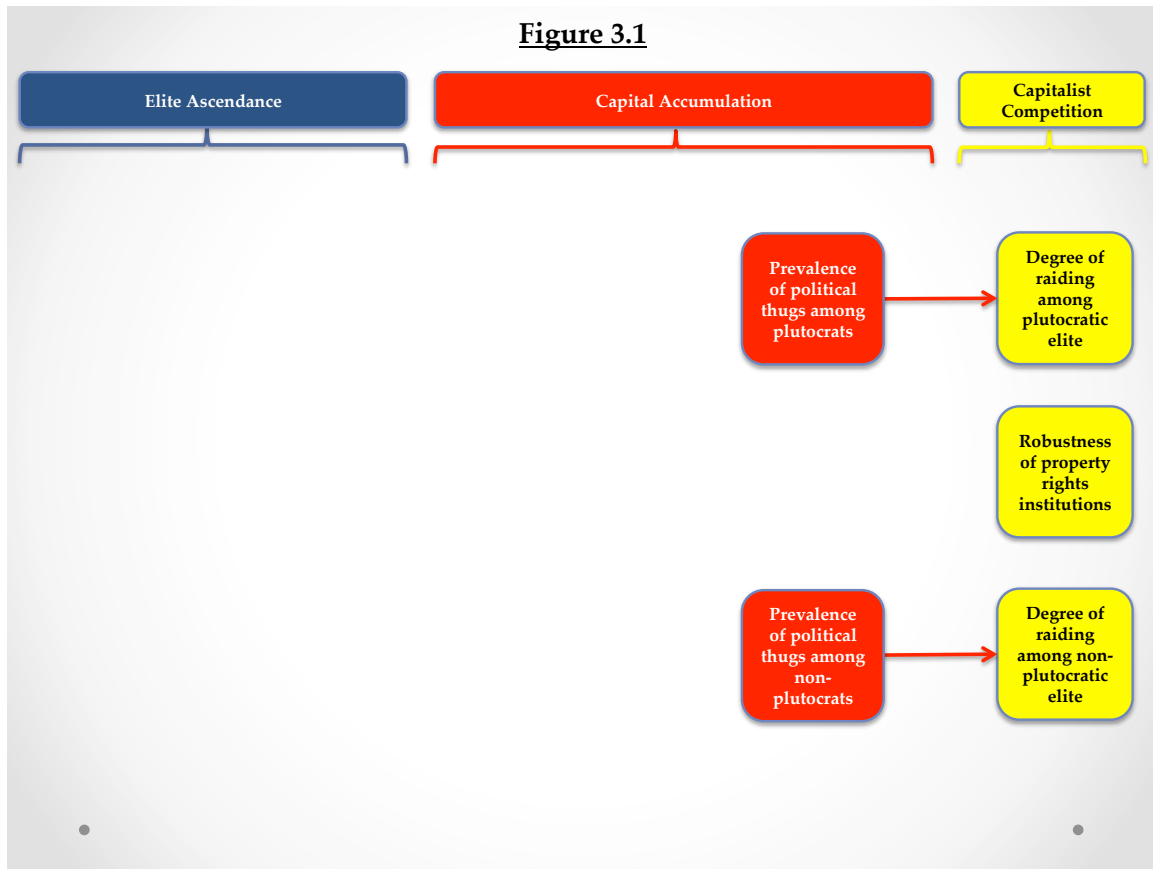
Capital Accumulation: Defining The Causal Variables

The immediate factor responsible for raiding among both elite strata is the prevalence of political thugs within each (see Figure 3.1). Recall the distinction drawn earlier between the three types of business actor typically found in an early capitalist environment. Entrepreneurs made their initial success in business solely by investing capital into the creation of productive assets. They did so with the intention of out-competing similar actors on quality and/or price. Crony capitalists started out by relying on both capital and coercive resources. Coercive resources can variously involve the capacity to use force directly or the ability to exploit one's political contacts inside the state's force-wielding organs. Political thugs are distinct from crony capitalists insofar as they acquired their initial fortune by virtue of coercive resources alone.

The prevalence of political thugs among the plutocratic and non-plutocratic elites represent two continuous variables. Each variable consists of the percentage of business actors within each stratum who can be defined as political thugs as opposed to crony capitalists or entrepreneurs.

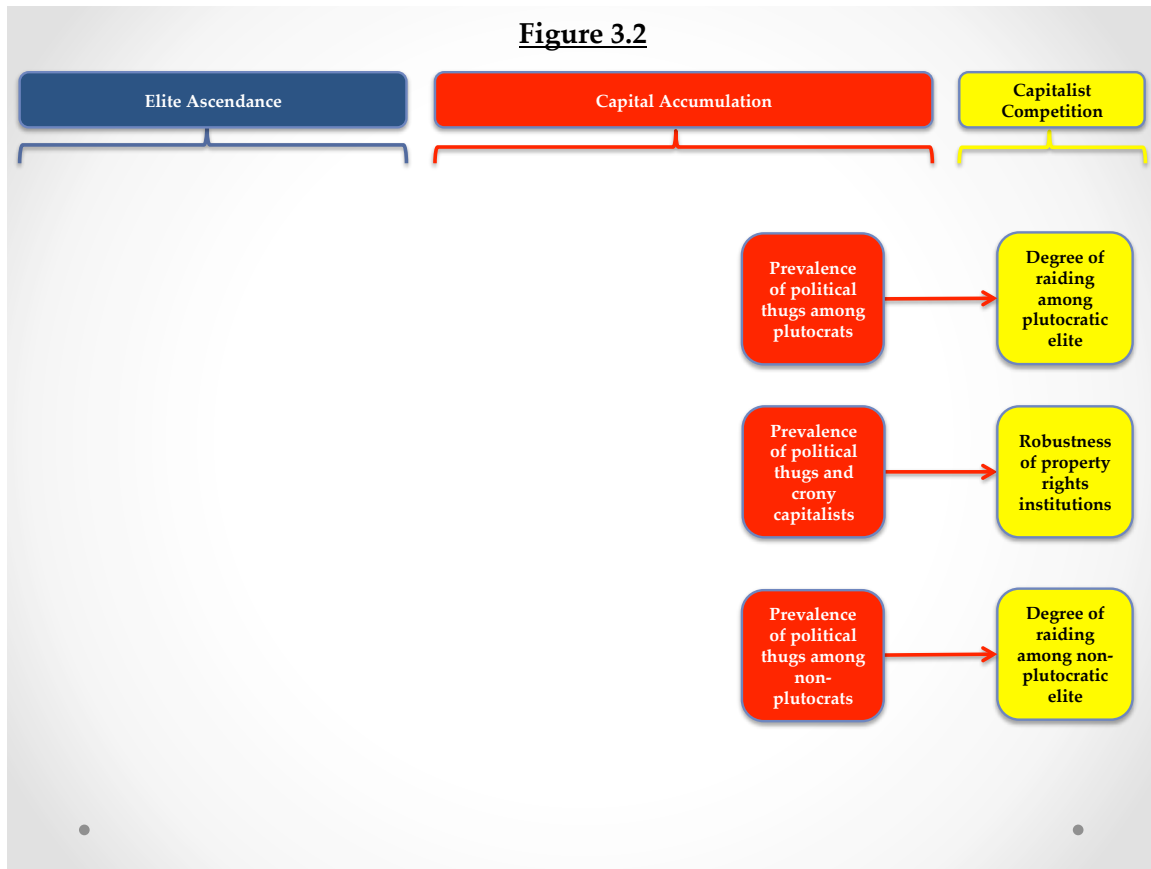
It must be stressed that not all political thugs necessarily use raiding as a business tactic. While being a political thug makes one much more likely to employ raiding, it hardly makes it inevitable. Many political thugs are satisfied to extract all of their income through soft budget constraints, especially when considering the potential blowback that can arise from expropriating others' assets (this will be discussed in a later

Business with Corrupt Regimes (London and Washington: Global Witness, 2009), available at <http://www.globalwitness.org/library/undue-diligence-how-banks-do-business-corrupt-regimes>.



section explaining why some actors raid while others do not). This helps account for why a relatively equal proportion of plutocrats in Slovakia and Ukraine have undertaken raids (47 percent and 35-45 percent, respectively) even though political thugs clearly comprise a greater share of the former's plutocrats than the latter's (Table 3.5). The choices of individual political thugs to either utilize or refrain from raiding are to a large extent idiosyncratic. Consequently, there is a considerable amount of randomness involved in the causal connection between the share of political thugs and the incidence of raiding. What we can say is that the *probability* of raiding increases in rough proportion to the percentage of political thugs that comprise the business elite.

If the frequency of raiding depended most immediately on the prevalence of political thugs, the presence of both political thugs and crony capitalists determined whether effective property rights institutions would develop (Figure 3.2). As we saw in Chapter One, not only political thugs but crony capitalists as well have an interest in corrupting and politicizing property rights institutions. To the extent that either type of actor gained a prominent position in the business world, such institutions faced powerful obstacles to becoming established. Only entrepreneurs could succeed in business without relying on political connections. Accordingly, it is only they who could be expected to refrain from attempts to corrupt property rights institutions while these institutions were still nascent and weakly established. Only where powerful networks of political thugs



and crony capitalists were relatively marginalized could property rights institutions have an opportunity to develop without falling under the influence of corrupt businesspeople.²

New institutions tend to be weak and vulnerable, especially when they lack any recent historical precursor in the societies in which they are imposed. The fewer people there are trying to corrupt them, the better chances they have for passing through this stage of vulnerability and attaining real authority. Based on findings from Estonia, Poland, Slovakia, and Ukraine, this study proposes the following hypothesis: the rise of robust property rights institutions requires the marginalization of those actors whose economic survival depends on corrupting them.

Not only did the predominance of political thugs affect the frequency of raiding; the resulting frequency of raiding influenced the predominance of political thugs (Figure 3.3). Where political thugs engaged in raiding with abandon, they amassed even more wealth which in turn served to increase their presence in the business environment relative to other actors. In this way, there were feedback effects between the extent to which political thugs comprised the population of business actors and the degree of criminal corporate raiding. This demonstrates a point made in Chapter One; phenomena occurring at later stages of early capitalism can turn around and shape those at preceding stages.

² Polishchuk.

Figure 3.3

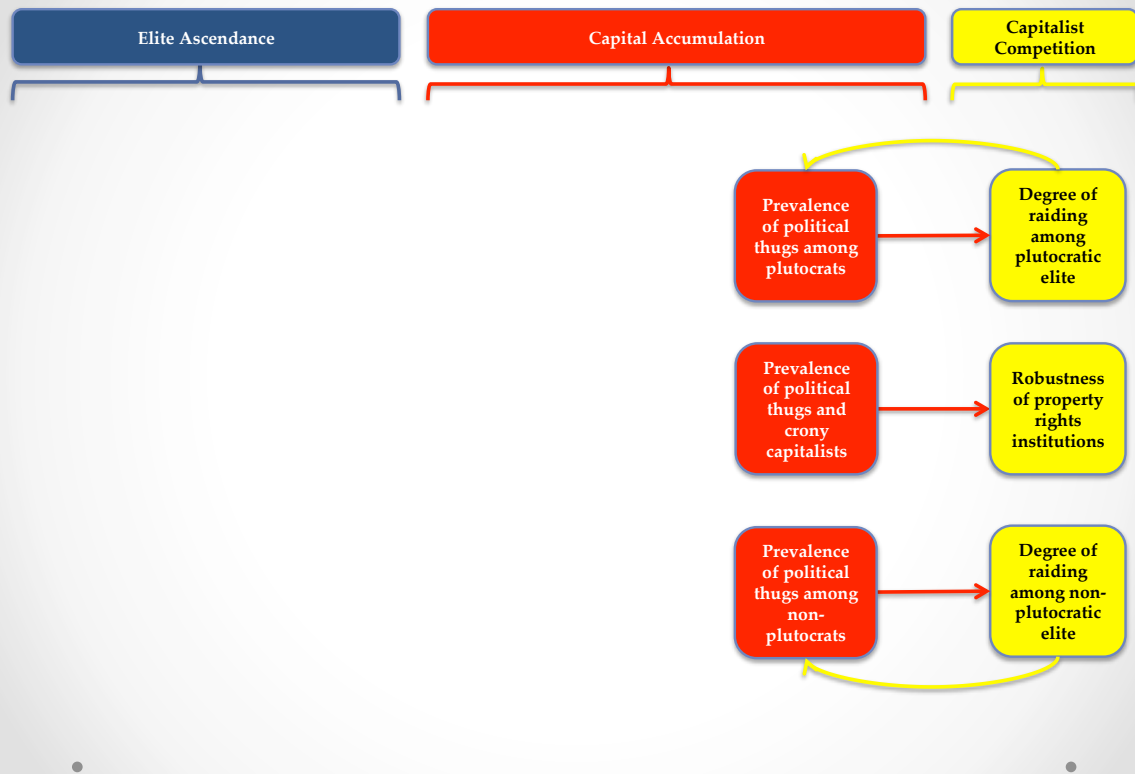
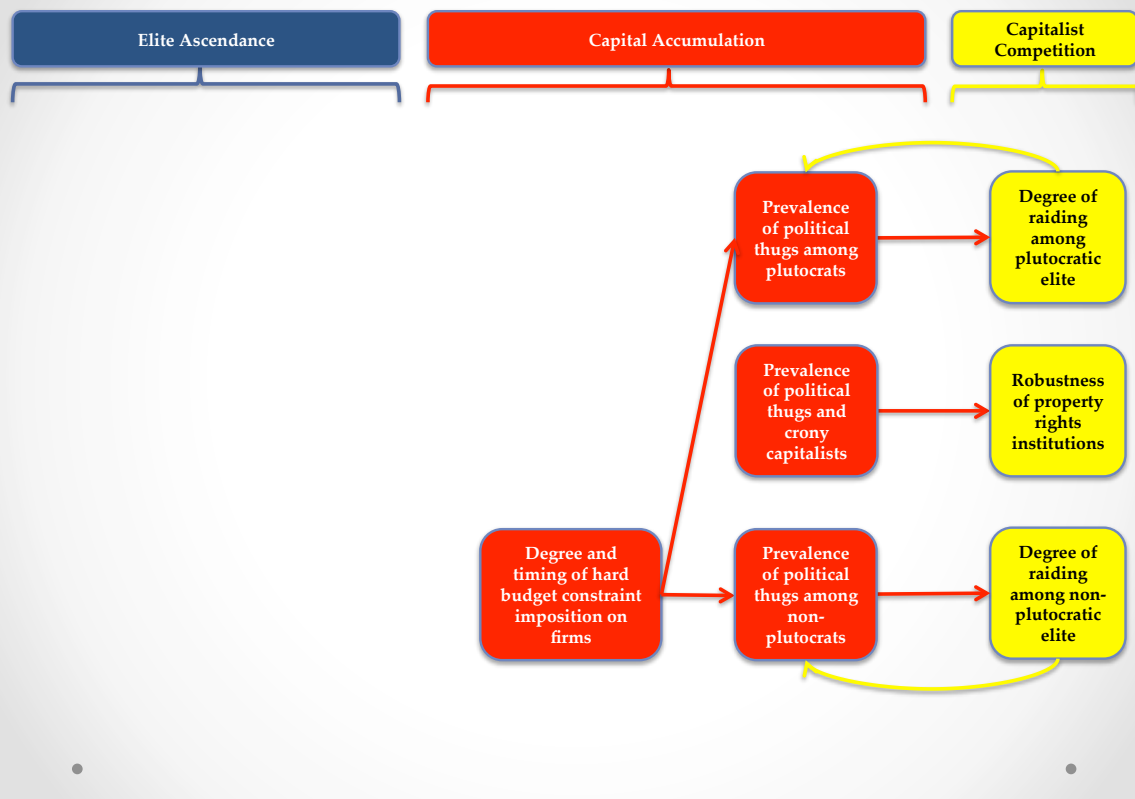


Figure 3.4



If the prevalence of political thugs accounted for raiding while that of political thugs and crony capitalists determined the possibility for property rights institutions to arise, what explained the relative predominance of these actors in the first place? The first factor is the degree to which early post-communist governments instituted hard budget constraints on firms along with the speed with which they did so (Figure 3.4). Soft budget constraints are the life source from which is born a powerful class of political thugs. They are what create this class, sustain it, and catapult it to predominance in the business world. Without access to soft loans, artificial price discrepancies, tax breaks, input-output schemes, underpriced privatizations, and overpriced state contracts, would-be political thugs cannot survive in business very long. Their competitive edge rests solely in their political access to the state's agents of force – those with the authority to make binding decisions on the allocation of resources and enforcement of rules. And soft budget constraints obtained thanks to these political connections are precisely what they need from the state in order to establish a solid foothold in business. To be sure, racketeers who start out by providing “protection” to firms might not depend on soft budget constraints to operate. But private protection can only get one so far; it is usually not sufficient to propel an actor into the upper ranks of the business elite. The real money starts flowing in once he manages to secure access to the open floodgates of state-backed funds.

Slightly adapting Kornai's classification, this study identifies four general types of soft budget constraint: (1) subsidies to enterprises allocated on political (as opposed to economically rational) grounds, (2) politically-allocated tax breaks to firms, (3) price controls enabling firms to exploit discrepancies between the prices of inputs and outputs, and (4) soft loans to financial intermediaries and other firms.³

Not all of these forms proved equally relevant in the post-communist countries. Enterprise tax arrears declined rapidly and substantially following the communist collapse not only in Estonia but in Poland and Slovakia as well.⁴ Direct subsidies to firms also fell sharply in Poland and Slovakia from 25.4 and 16.3 percent in 1986 to 4.8 and 2.5 percent by 1992, respectively.⁵

However, most measures of subsidies do not take into account underpriced privatizations and overpriced state contracts – even though these too represent subsidies. When the state privatizes a company for less than it is worth, this is just as much a subsidy as more conventional sorts of transfers such as the provision of cheap state electricity to private firms. The same is true in the case of a contract awarded at an inflated price to a politically favored firm to provide services to the state; as Chapter One showed, this is little different, in either form or effect, from propping up a loss-making enterprise through a direct transfer of state funds. While it would be difficult to obtain an accurate measure of the precise magnitude of these subsidies, the evidence from the ensuing chapters will make their importance abundantly clear. In addition to subsidies,

³ Kornai, *The Socialist System: The Political Economy of Communism*.

⁴ Tax arrears fell to 5.7% in Estonia by 1994, 5-7% in Poland by 1994, and 4.5% in Slovakia by 1993. See Schaffer, "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence."

⁵ Mark E. Schaffer, "Government Subsidies to Enterprises in Central and Eastern Europe: Budgetary Subsidies and Tax Arrears," in *Tax and Benefit Reform in Central and Eastern Europe*, ed. David M. G. Newbery (London: Centre for Economic Policy Research, 1995), Table 5.1.

other important forms of soft budget constraints in transition economies tended to consist of tax arrears, incomplete price liberalization, and, especially, cheap loans.

The importance of soft loans finds support among other scholars. For instance, after showing that direct subsidies along with inter-enterprise arrears had declined sharply, Blanchard states: “The main source of hidden subsidies however has been bank loans. Given that the banking system had traditionally been a conduit for government transfers to firms, and remained state owned, many state firms were initially able to get loans to cover their losses.⁶ Dudzinski et al. also detail how bad loans built up inside Poland’s state banks in the early and mid-1990s to the point that they threatened the stability of the financial system.⁷ Referring to the Czech Republic, Schwartz too notes that “tunneling... was manifest in the explosion of bad debt on bank and state agency books” and that “[t]he state’s absentee ownership of banks was a precondition for bank IPF managers to abuse agent and ownership rights (and for bank lending policies to spin out of control). Furthermore, he describes how the central bank recapitalized banks whose NPL portfolios had reached crisis proportions.⁸

Whether or not the first post-communist government took immediate and decisive action to harden budget constraints would have a tremendous effect on the character of the business elite. Where soft budget constraints were widely available, they would put state assets and funds into the hands of budding political thugs and crony capitalists. The resulting surplus of political thugs would lead to rampant raiding while the combined prevalence of political thugs and crony capitalists would ensure that property rights institutions remained enfeebled. The extent to which hard budget constraints were imposed represents a dichotomous variable; the first post-communist government either did or did not take such action and take it within the first year of post-communist rule.

In Slovakia, Poland, and Ukraine, governments did not undertake adequate measures to harden budget constraints. In these countries, the extent of price liberalization two years into the transition fell behind that of Estonia by 10 percent, 20 percent, and 100 percent, respectively.⁹ Clearly, incomplete price liberalization did not play an equal role in the three countries but they did not have to; where price controls existed to any significant degree they would provide opportunities for political thugs to amass wealth. As the country chapters will show, incomplete price liberalization did serve as a key soft budget constraint enabling political thugs to pilfer state enterprises, especially in Poland and Ukraine.

Aside from partial price liberalization, the first post-communist governments in Poland, Slovakia, and Ukraine also failed to sufficiently rein in the spread of soft loans in the banking system. Banks continued propping up enterprises with cheap loans without any regard for ensuring such loans went only to firms that were well-capitalized and earned sufficient revenues to repay them. Governments and central banks did not

⁶ Oliver Blanchard, "Transition in Poland," *The Economic Journal* 104, no. 426 (1994): 1170.

⁷ Andrzej Dudzinski and Krystyna Szymkiewicz, "Privatisation of Banks and Firms: The Polish Route," in *Privatisation and Structural Change in Transition Economies* ed. Yelena Kalyuzhnova and Wladimir Andreff (New York: Palgrave-Macmillan), 228-30.

⁸ Schwartz, 230, 238-39, 248.

⁹ These figures come from the EBRD’s “price liberalization” indicator, which is one of the Transition Indicators the bank publishes annually. The data for Estonia and Ukraine are from 1993 and 1991 for Poland and Slovakia (two years into each country’s post-communist transition). Data is available at <http://www.ebrd.com/pages/research/economics/data/macro.shtml>.

adequately supervise bank lending and in some cases continually replenished banks with new loans after the old ones had become non-performing. Many of the soft credits extended to banks and other enterprises were frequently diverted into the pockets of those who controlled these firms as well as their political protectors. Importantly, it was not only loans initiated in the post-communist era that mattered. Where the first post-communist governments failed to clean up the bad debts inherited from communist times, heavily-indebted enterprises could survive. And as long as they survived, they would allow the budding political thugs who controlled them to remain viable.

Additionally, the insolvent firms themselves would serve as a potential trough for soft budget constraints, usually in the form of input-output schemes, that would feed this newly emerging class of political thugs. This was especially true where state banks continued rolling over old non-performing loans into new and equally non-performing loans. The effective implementation of hard budget constraints would thus require an adequate cleanup of communist-era NPLs and not just the elimination of new soft loans in the post-communist period. Insolvent enterprises with unpayable debts would have to be closed along with the insolvent state banks on whose books the unpayable debt resided.

Finally, as stated above, subsidies in the form of cheap privatizations and inflated state contracts would also prove important in tilting the balance against entrepreneurs and in favor of political thugs.

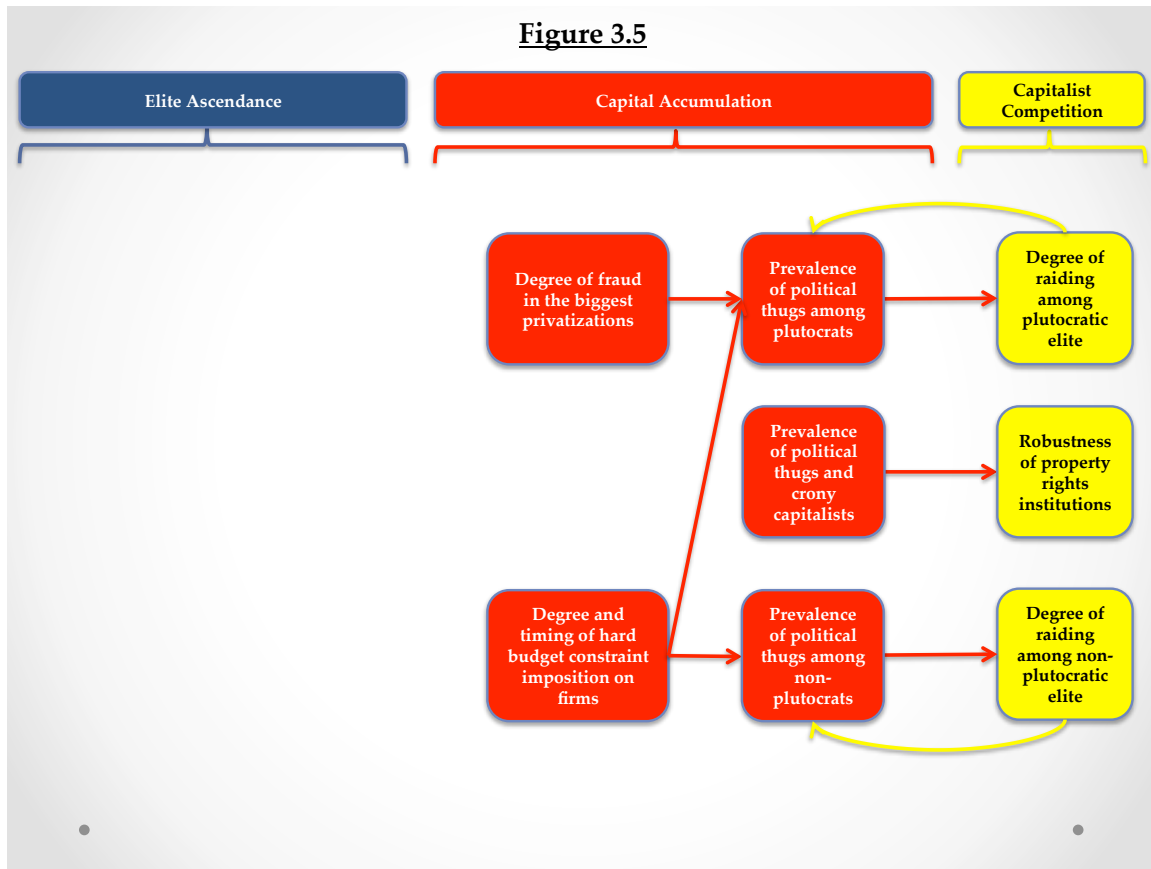
Estonia managed to avert this scenario thanks to the swift and resolute action of its first post-communist government to impose hard budget constraints. Indeed, Estonia is the only country in this study and quite possibly the entire post-communist region where such dramatic measures were implemented. In October 1992, the liberal Pro Patria coalition headed by Mart Laar came to power, carried out immediate and complete price liberalization, and allowed insolvent banks to fail.¹⁰ It additionally installed a draconian currency board arrangement that severely limited the state's ability to prop up the financial intermediaries that remained. Furthermore, it developed an effective means of supervising the surviving banks to make sure lending did not spiral out of control.¹¹

The timing with which these measures were adopted proved critical (Figure 3.4). In order to prevent state resources from falling into the hands of budding political thugs, governments had to institute hard budget constraints upon firms within the very first year of post-communist rule. Even countries that did adopt such measures but waited two, three, or more years to do so risked allowing political thugs to rise to predominance by exploiting continued access to state resources. Speed was also important insofar as the governments that did choose to harden budget constraints might very well find themselves out of power after only a few years; Laar's government would barely last two.

The extent and speed with which early post-communist governments instituted hard budget constraints not only determined the proportion of the non-plutocratic elite that would consist of political thugs. It also affected the percentage of the *plutocratic* stratum would become comprised of political thugs (Figure 3.4). Those political thugs who came to populate the ranks of society's very wealthiest private businesspeople

¹⁰ "Country Report: Estonia," *Economist Intelligence Unit* no. 1 and no. 3 (1993).

¹¹ Riina Kionka, "Free Market Coalition Assumes Power in Estonia," *RFE/RL Research Report*, 20 November 1992.



required appropriately vast amounts of state support in the form of soft loans, rigged tenders, artificial price discrepancies, and the like.

However, there was one particular form of soft budget constraint that distinctly affected the makeup of the plutocratic elite. This was the extent of fraud in the biggest privatizations (Figure 3.5). Privatization fraud refers to the act of ensuring the sale of a state enterprise at below-market cost to a pre-arranged buyer in a rigged tender. Note that a low sale price does not by itself provide any indication of fraud. Many perfectly above-board privatizations involved the sale of an enterprise at a price that was well below-market. But these auctions typically came with a formal commitment from the buyer to make a significant capital investment into restructuring the firm. The legitimacy of a given privatization should thus be judged by the *total* price the buyer incurred, in both its monetary and non-monetary elements, and not simply the monetary price that was paid. By allowing the winner to buy the company at a below-market price, a fraudulent privatization amounts to a subsidy, reducing the expenditure that the buyer must incur in order to purchase the firm.

Fraudulent privatizations eliminated from contention those actors who lacked the political connections necessary to gain access – that is, entrepreneurs. They rather placed state assets into the hands of those who did have such connections – crony capitalists and political thugs. Where the largest privatizations were marred by blatant fraud, they tilted the plutocratic playing field in favor of the latter two actors (Figure 3.5).

Also, not just any fraudulent privatization can prove sufficient for propelling a political thug into the ranks of the plutocrats. Only where the very largest state

enterprises are privatized in this manner could their acquisition transform an otherwise hapless degenerate completely devoid of any real entrepreneurial talent into a commercial magnate. Countries that witnessed rampant fraud in the privatization of the largest enterprises subsequently ended up with a high proportion of political thugs among the plutocratic elite. In many cases, the acquisition of even a single firm in a rigged auction could suddenly catapult a well-connected individual into the big-time.

Where the state's crown jewels were privatized without blatant fraud, as in Poland and Estonia, the plutocratic elite was likely to be marked by a relative paucity of political thugs. To be sure, many political thugs acquired enough capital to participate in small- and medium-sized privatizations. But where the largest privatizations allowed true competition among multiple bidders, political thugs tended to find themselves priced out; on the whole, they lacked the substantial capital required to win a fair contest. And even for those political thugs who eventually did amass large sums of money, honestly-conducted privatizations posed the possibility that they might actually lose. Either way, large privatizations carried out on legal, honest terms – or at least without overt fraud – tended to select against political thugs and in favor of crony capitalists and entrepreneurs. The result typically was a smaller presence of political thugs among the plutocratic elite. The degree of fraud in the biggest privatizations is a continuous variable and is represented by the percentage of such privatizations that were indeed fraudulent.

Although privatization fraud facilitated the emergence of many plutocratic political thugs, it was not essential in all cases; many political thugs attained plutocratic status from other kinds of soft budget constraints such as fat state contracts. Because these other forms of soft budget constraints offered the possibility to make connected businesspeople very rich, corruption in the largest privatizations was technically not necessary to ensure that the plutocratic elite would contain a large number of political thugs. However, it certainly made this outcome more likely. And if a country was to avoid seeing political thugs populate the ranks of its ultra-wealthy, the avoidance of major fraud in the biggest privatizations *was* necessary. If governments could manage to oversee a relatively clean privatization process, they would cut off one important avenue for political thugs to make it into the plutocratic stratum. All the same, so long as other avenues were available, then some political thugs could very well become plutocrats. This explains why the plutocratic elites of Estonia and Poland are not completely devoid of political thugs. In both countries, the lack of privatization fraud ended up limiting the share of political thugs among the plutocrats. But other kinds of highly lucrative soft budget constraints remained available in some instances. This accounts for why the plutocratic elites in the two countries did end up with as many political thugs as they did, even if the total share of plutocratic political thugs was substantially lower than in Slovakia and Ukraine.

An additional point that is important to note is that privatization fraud did not always take the conventional form of rigged state tenders. As we saw in the previous chapter, post-communist countries used a wide range of privatization methods from public tenders and stock market sales to voucher privatizations. In Slovakia, in particular, the voucher privatization process of the early 1990s ended up putting a multitude of small shareholdings in large state companies into the hands of a few investment funds. Established during the voucher privatization process before the breakup of Czechoslovakia, the investment funds bought up vouchers from citizens in

return for shares in the funds. They then used the vouchers to participate in privatization auctions, ultimately obtaining small but significant shareholdings in many blue chip companies.

The initial process by which the funds obtained these stakes was relatively honest, at least in the Slovak part of the country. But when Mečiar came to power for the third time in 1994, he sought to redistribute these assets to his cronies. He did so by helping them engineer highly questionable takeovers of a number of the largest investment funds. Some of these takeovers qualify as raids, as they involved the acquisition of privately-owned companies through the illegal use of force. But they must also be seen as part of the voucher privatization process; they constituted the culmination of the redistribution of these state assets. The funds held private stakes in companies that until very recently were in state hands. Ultimately, the funds simply acted as temporary way stations for the assets as they passed from state to private ownership.

Aside from influencing the presence of political thugs, corruption in the largest privatizations along with soft budget constraints more generally likewise helped place crony capitalists into the business elite (Figure 3.6). What makes crony capitalists distinct is that *both* political connections *and* value-adding investments are important in their rise to wealth. Quite often, the very purpose of using political connections is to secure soft budget constraints, at least during the early stages of the crony capitalist's business career (until her assets reach the point at which they can add economic value on their own without soft budget constraints). Many crony capitalists continue relying on soft budget constraints, at least in part, even after they have become long-established members of the economic elite.

Importantly, there were feedback effects between the degree to which hard budget constraints were implemented, the predominance of political thugs, and the frequency of raiding (Figure 3.7). In particular, if soft budget constraints served to enrich and empower political thugs, by doing so they placed these political thugs in a better position to arrange for even greater soft budget constraints thereafter. The more political influence political thugs wielded, the greater their ability to secure still more access to fraudulent privatizations, soft loans from state banks, and rigged tenders for public procurement. Likewise, by depriving incipient political thugs of state largesse, hard budget constraints left these actors with far less wealth and, in turn, political influence to secure such largesse. Furthermore, the acquisition of greater wealth through criminal corporate raiding served to boost the power and influence of political thugs which in turn enhanced their ability to obtain additional soft budget constraints.

Similarly to soft budget constraints in general, there were feedback effects between privatization fraud, the makeup of the business elite, and raiding (Figure 3.8). By placing these huge assets in the hands of political thugs, a corrupt privatization process left such individuals in an even stronger position to engineer similarly fraudulent privatizations thereafter. They now possessed greater wealth with which to influence appointments in the state administration and bribe any state officials responsible for overseeing privatization. However, where the largest privatizations were conducted relatively honestly, political thugs tended to find themselves cut out of the process; on the whole, only those with enough capital – that is, entrepreneurs and crony capitalists – can prevail in a fair privatization. By tilting the balance within the plutocratic elite in favor of political thugs, fraudulent privatizations increased the likelihood that future

Figure 3.6

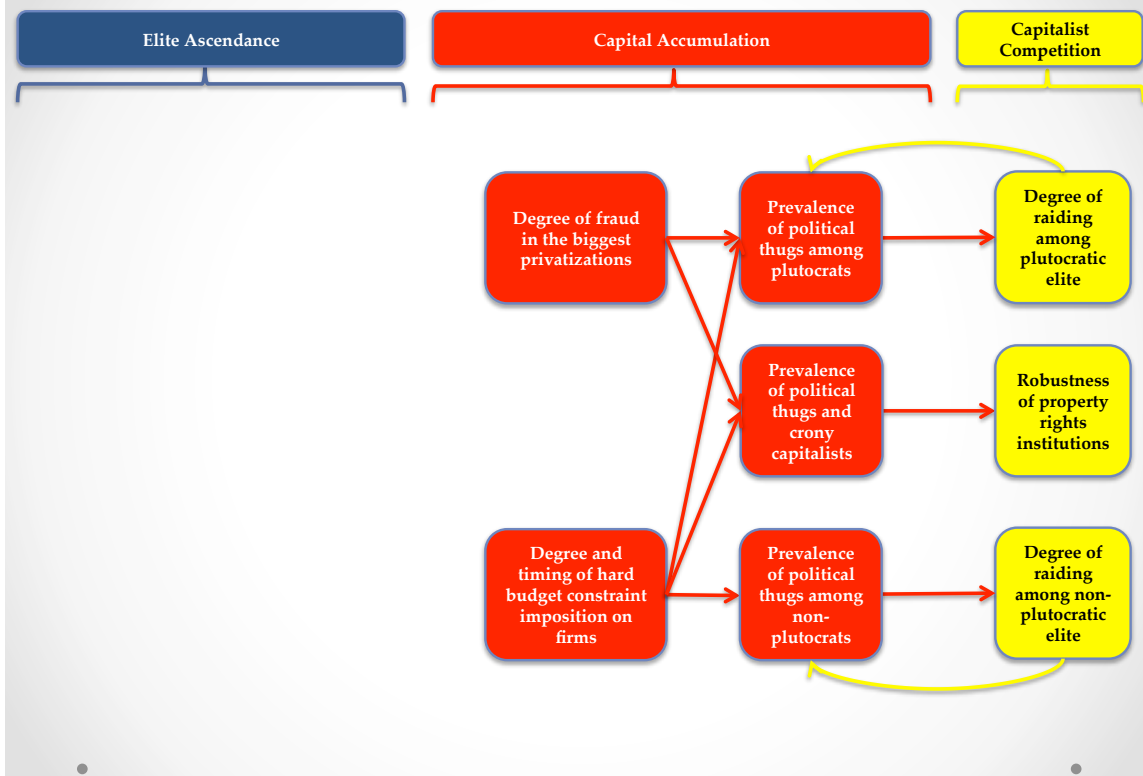
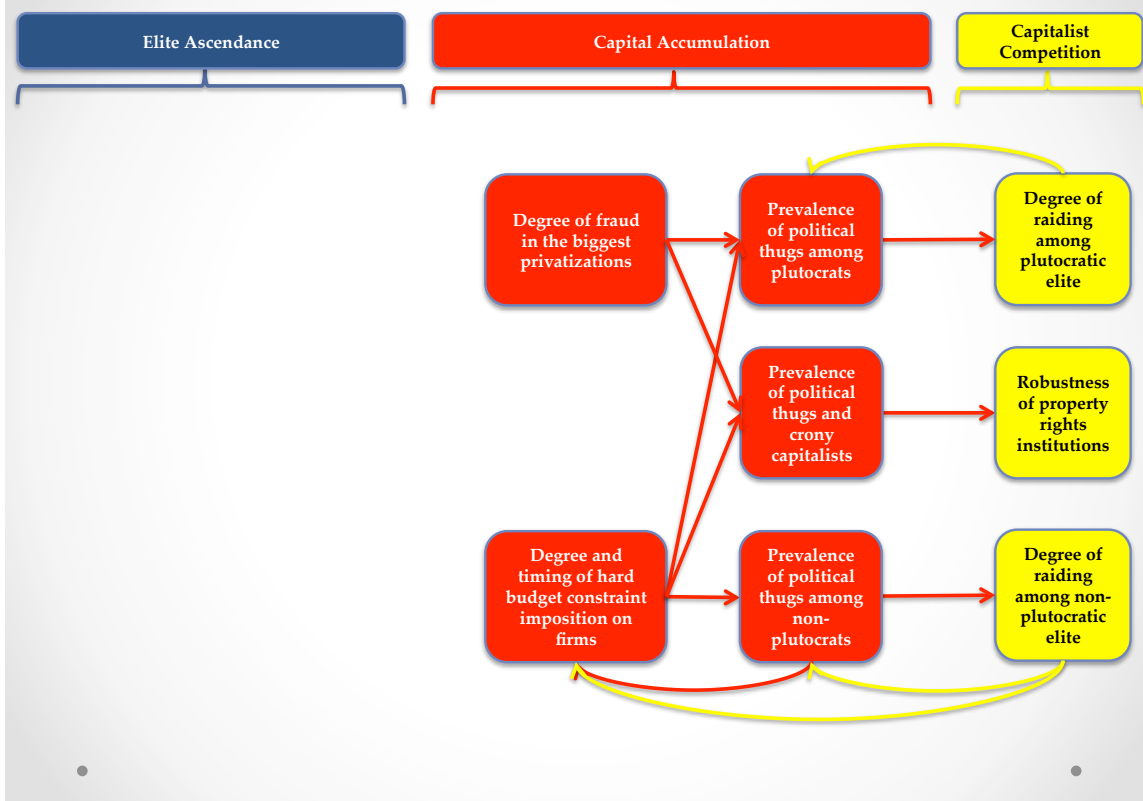
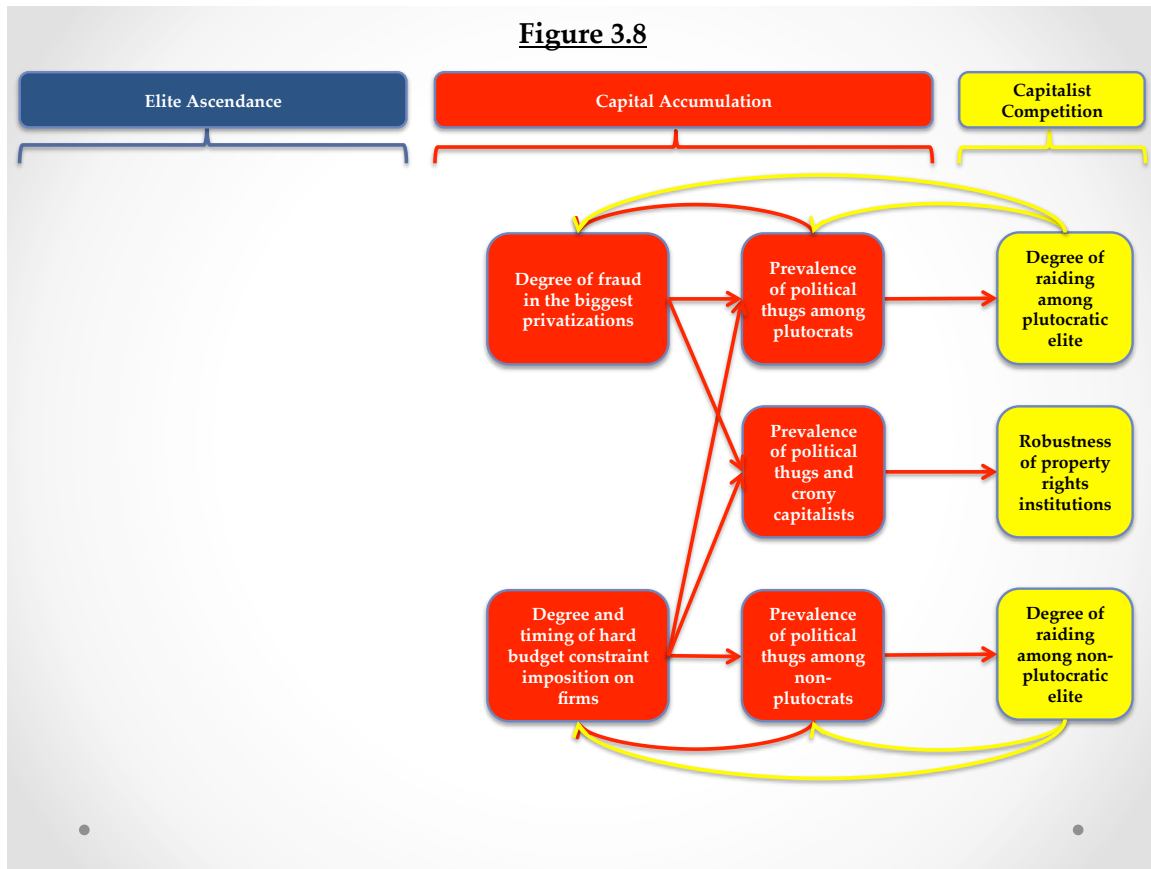


Figure 3.7





privatizations too would be marred by massive corruption. Likewise, as political thugs amassed more wealth through criminal corporate raiding, they gained more political influence that could then be used to engineer further corrupt privatizations.

The emphasis on the importance of hard budget constraints differentiates this study from much of the literature on post-communist political economy. The main focus of this literature tends to be on economic reform writ-large rather than the distinct effects of its individual components. Countless studies have examined the impact of the whole package of economic reforms recommended by the international financial institutions.¹² Some, in the spirit of Polanyi,¹³ have criticized these reforms for severing the individual from the social and economic supports necessary for basic economic sustenance.¹⁴ Others have warned of the perils of “partial reform,” in which governments implement part of the package without going the whole way.¹⁵ What unites all of these studies is a

¹² There are far too many to cite. But see, for instance, Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions."; Shleifer and Treisman; Oleh Havrylyshyn, "Fifteen Years of Transformation in the Post-Communist World: Rapid Reformers Outperformed Gradualists," *CATO Institute Development Policy Analysis No. 4*, 9 November 2007; Grzegorz W Kolodko, "Transition to a Market Economy and Sustained Growth: Implications for the Post-Washington Consensus," *Communist and Post-Communist Studies* 32, no. 3 (1999); M. S. Fish, "The Determinants of Economic Reform in the Post-Communist World," *East European Politics & Societies* 12, no. 1 (1997); Herrera.

¹³ Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon, 2001 [1944]).

¹⁴ Cohen.

¹⁵ Hellman, "Winners Take All: The Politics of Partial Reform in Postcommunist Transitions."

preoccupation with economic reform as a whole without considering which specific reforms might be most instrumental in generating certain outcomes. The main exception, of course, is the voluminous literature on privatization, most of which concerns the relative merits of different privatization methods.

Fewer specialists have specifically analyzed the hardness of budget constraints,¹⁶ much less its impact on economic criminality and the effectiveness of legal property rights institutions. Yet it was precisely this element of economic liberalization that would prove most instrumental in shaping post-communist capitalism.

Plentiful access to state credits, subsidies, and other soft budget constraints are absolutely critical to the budding raider. This is true not just of private business actors. It also applies to state officials who become raiders in their own right.¹⁷ Before embarking on a raid, these “official” political thugs must have already appropriated at least partial private control over the state resources necessary to carry it out. For instance, to the extent that the use of certain state regulatory bodies is required to put pressure on the takeover target, the official raider must be able to rely on the diversion of personnel and funds from these agencies toward support of the raid. What this amounts to is the provision of a soft loan to the state official; the state assets are “lent” to that official – on purely political rather than economically rational grounds – thereby freeing him of the need to marshal his own private funds to finance the takeover.

Capital Accumulation: Measuring the Variables

In sum, where soft budget constraints were plentiful, they enriched and empowered an emerging class of political thugs and crony capitalists. Where they were limited, such actors tended to find themselves marginalized.

The question remains as to how these various phenomena – the hardness of overall budget constraints, the fairness of the biggest privatizations, and the relative proportion of political thugs and crony capitalists in the business elite – are to be measured. Turning first to the extent of fraud in the largest privatizations, one possible method is to count how many of these involved sales at below-market cost. However, assessing the “proper” market value of a given firm is far from straightforward. It also forces one to draw that inevitably arbitrary line after which the cost incurred by the buyer moves from fair to unjustifiably low.

An easier method is to look at the auctions themselves and count the number that were visibly rigged. To this end, I analyzed the ten largest privatizations in Poland,

¹⁶ There are, of course, exceptions. See, for example, Kornai, *The Socialist System: The Political Economy of Communism*; Berglof and Roland, "Soft Budget Constraints and Banking in Transition Economies."; Claessens and R. Kyle Peters Jr., "State Enterprise Performance and Soft Budget Constraints: The Case of Bulgaria."; Schaffer, "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence."; Dewatripont and Roland, "Soft Budget Constraints, Transition, and Financial Systems."; Frydman et al., "The Limits of Discipline. Ownership and Hard Budget Constraints in the Transition Economies."; Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries."; Dariya Mykhayliv and Klaus G. Zauner, "Investment Behavior and Ownership Structures in Ukraine: Soft Budget Constraints, Government Ownership and Private Benefits of Control," *Journal of Comparative Economics* 41, no. 1 (2013).

¹⁷ On the increasing role of state officials (as opposed to private racketeers) in orchestrating attacks, see Gans-Morse, "Threats to Property Rights in Russia: From Private Coercion to State Aggression."

Slovakia, and Ukraine. (In Estonia, I was not able to gather enough data in order to run the analysis.) The sales were ranked by multiplying the firm's revenues one year prior to the privatization by the percentage of the stake that was sold. I compiled a list of indicators that are suggestive of possible fraud and applied these indicators to each privatization. The three countries could then be compared by counting the number of privatizations that appear to have been fraudulent.

The value in these indicators is that they avoid dependence on arbitrary judgment calls as to what constitutes a "fair" price for a firm. They instead relate solely to the conduct of the privatization itself. For instance, when competing bids are excluded on arbitrary grounds that have nothing to do with economic rationality, this indicates that fraud took place. When a marginal and previously unknown entity comes out of nowhere to land a huge privatization contract, this likewise suggests the occurrence of fraud. When the winner of a privatization turns out to have made illegal campaign contributions to the ruling coalition, this provides yet another indication of corruption. While legal campaign donations are often made without any anticipation of a favor in exchange, nobody would assume the risk of financing an election campaign in blatant *violation* of the law without expecting something in return (such as a rigged privatization). A full list of the indicators I used is included in Appendix I. It is broken down according to those that are sufficient by themselves to indicate fraud and those that, while suggestive of fraud, are not sufficient on their own to draw such a conclusion.

What were the results? In Ukraine, at least eight, if not nine, of the ten biggest privatizations were marked by serious fraud. In Poland, none exhibited any such signs of major corruption. Slovakia was a mixed case; there, four of the top ten sales satisfied at least one sufficient indicator of fraud. But the ten largest Slovak privatizations, if considered alone, obscure the high degree of corruption that marked the broader privatization process. The six privatizations that did not display any of the sufficient indicators of fraud all took place during a brief two-year window from 2000 to 2002. At the time, a relatively reformist government was in power and was on its best behavior as Slovakia's accession to the European Union was drawing nearer. Should the positive influence of the EU in this period be taken as evidence that the prospect of European integration was indeed an important factor in preventing privatization fraud more generally? Does it not show that the possibility of EU accession should be included as an additional variable in the overall causal framework? Not when one considers all of the corrupt privatizations that occurred before and after this short two-year period (including most of the next ten biggest privatizations) of which we will see plenty of evidence in the Slovakia chapter. Evidently, the influence of the EU was not sufficient to prevent that.

Nor was it enough to limit the *real* episode of privatization fraud. This occurred during the mid-1990s when a group of political thugs took over the investment funds. Technically, the IPFs were private companies which themselves had already bought many small stakes in blue-chip companies. As a result, the takeovers of the funds do not show up on the list of the top ten privatizations. But they do represent the final stage of the Slovak voucher privatization process and will be considered as such. A substantial amount of public information is available that documents how these transactions proceeded. The very nature of the process itself revealed the highly dubious character of the transactions, as will become evident in the chapter on Slovakia.

As mentioned above, I was not able to find enough data to carry out the analysis of the top-ten privatizations in Estonia. However, I was able to gather a sufficient amount of information from interviews and media sources which, taken together, conclusively demonstrates the predominantly fair and honest nature of the Estonian privatization process. Unlike the other three countries, Estonia carried out privatization in close consultation with West European advisors, particularly the German *Treuhand*. Of course, there were exceptions, as we will see. But overall, the Estonian Privatization Agency, which had direct responsibility for the process, was widely lauded for the independent and transparent way it sold off the bulk of the country's state enterprises. All of my respondents who commented on the sales, even those who were critical of other instances of government corruption, universally affirmed the honest and procedure-driven approach that characterized Estonian privatization.

Of course, fraudulent privatizations are hardly the only kind of soft budget constraint that can facilitate the rise of a class of political thugs. Other kinds of subsidies along with soft loans and price controls can lead to the same outcome. These additional forms of soft budget constraints must be measured too. To this end the EBRD provides three indicators that reflect the extent to which hard budget constraints were imposed. *Price liberalization*, as the name implies, seeks to measure the extent to which prices can form independently of state control. *Banking reform and interest rate liberalization* captures the degree to which the government and central bank have imposed appropriate legal frameworks and prudential supervision on bank lending. *Governance and enterprise restructuring* measures the existence of hard budget constraints at the enterprise level and effective tight credit policies by the government and central bank.¹⁸ To measure the speed with which these reforms were implemented, I will use the score a given country attained during the second year of its post-communist transition (1991 for Poland and Slovakia, 1993 for Estonia and Ukraine). Table 3.1 includes a composite score for each country on all three indicators. Estonia clearly stands apart from the others in the extent to which economic actors swiftly became subject to hard budget constraints. It scores 27 percent above Poland, 23 percent above Slovakia, and 73 percent above Ukraine.

That said, statistics like these can obscure important developments happening beneath the surface (like the continued provision of soft credits to state banks in Czechoslovakia and Poland). To drill down to a greater level of detail, evidence from country newspapers along with secondary sources will be used to complement the EBRD data.

In addition to the EBRD measures, the prevalence of soft loans in the economy can also be assessed by looking at the percentage of non-performing loans (NPLs) as a proportion of all loans outstanding in the financial system. Banks and other financial intermediaries¹⁹ played a pivotal role in propelling political thugs to economic dominance. They did so by providing a continuous flow of soft loans that quite frequently were never repaid. In other instances, the loans would eventually be repaid

¹⁸ For more information on how the Transition Indicators are measured, see http://www.ebrd.com/pages/research/economics/data/macro/ti_methodology.shtml.

¹⁹ The other financial intermediaries that both exploited and provided soft budget constraints were the Investment Privatization Funds (IPFs), especially in the Czech Republic. See Gould, 81-89.

Table 3.1: The Degree and Speed with which Hard Budget Constraints were Instituted (1-2 years into transition)

	<u>Enterprise Restructuring</u>	<u>Price liberalization</u>	<u>Banking Reform</u>	<u>Average</u>	<u>% Difference from Estonia</u>
Estonia (1993)	3.00	4.33	3.00	3.44	
Poland (1991)	2.00	3.67	2.00	2.56	-26.6%
Slovakia (1991)	2.00	4.00	2.00	2.67	-23.3%
Ukraine (1993)	1.00	1.00	1.00	1.00	-73.4%

Source: EBRD Transition Indicators
(<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

but would never have been issued in the first place if not for the political connections of the recipients.

NPL levels varied widely across countries. By Laeven & Valencia's estimation,²⁰ bad loans reached as high as 75% of all loans outstanding in Bulgaria, where siphoning became a veritable craze in the 1990s comparable to the jazz mania of the 1920s.²¹ However, for the purpose of this study, one particular country stands out for its especially low level of NPLs. That country is Estonia, which emerges heads and shoulders above all other countries in post-communist Europe. During the 1990s, when political thugs elsewhere were getting rich from the theft of state assets, Estonia's average annual NPL level was a mere 3.2 percent of all outstanding loans. This contrasts with Poland and Slovakia, where the average reached 21 and 32 percent of all loans, respectively (Table 3.2).²² Figure 3.9 shows how the NPL problem unfolded over time in Estonia, Poland, and Slovakia (Ukraine could not be included due to insufficient data – see below).

But the average figures mask an additional interesting pattern. This is the scale of the NPL problem at its peak along with the particular year in which the peak was attained. Laeven & Valencia calculated peak NPL levels across a range of countries during systemic banking crises.²³ Their data can be used to corroborate the data from Table 3.2, which comes mostly from the EBRD, showing just how bad the problem became at its very worst (Table 3.3).

In Estonia, NPL levels peaked at only 7 percent. Moreover, the peak occurred in 1992-93, barely one-and-a-half years after the collapse of communism. This reflects the fact that the first post-communist government took swift action to rein in soft loans extended on political rather than economically rational grounds (Tables 3.2 and 3.3). By nipping the problem in the bud, the government ensured that relatively few would-be political thugs rose to positions of real prominence in post-communist Estonia.

²⁰ Luc Laeven and Fabian Valencia, *Systemic Banking Crises: A New Database* (International Monetary Fund, 2008).

²¹ Multigroup Owes 91 Bn Levs in Bad Debts." *Capital Weekly*, January 26, 1998; *Partners in Crime: The Risks of Symbiosis between the Security Sector and Organized Crime in Southeast Europe*, 22-25.

²² Table 3.2 displays NPL data from 1991 all the way through 2000.

²³ Laeven and Valencia.

Table 3.2. Non-Performing Loans as % of All Loans, 1991-2000

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Avg.
Estonia			7.0	3.5	2.4	2.0	2.1	4.0	2.9	1.3	3.2
Slovenia				13.8	9.3	10.1	10.0	9.5	9.3	9.3	10.2
Latvia				11.0	19.0	20.0	10.0	6.8	6.8	5.0	11.2
Hungary	11.0	21.0	29.6	20.2	12.1	9.0	6.6	7.9	4.4	3.1	12.5
Belarus				8.4	11.8	14.1	12.5	16.5	13.1	15.2	13.1
Croatia				12.2	12.9	11.2	8.2	12.6	20.6	19.8	13.9
Serbia & Montenegro				10.3	12.0	12.3	15.1	13.1	10.2	27.8	14.4
Bulgaria	40.0		6.7	6.8	12.5	15.2	13.0	11.8	17.5	10.9	14.9
Lithuania				27.0	17.3	32.2	28.3	12.5	11.9	10.8	20.0
Poland	17.0	27.0	36.4	34.0	23.9	14.7	11.5	11.8	14.9	16.8	20.8
Czech Republic	3.0	19.0	22.0	34.0	26.6	21.8	19.9	22.7	43.4	39.7	25.2
Romania	6.0	5.0	4.0	18.5	37.9	48.0	56.5	58.5	35.4	3.8	27.4
Slovakia	3.0	19.0	12.2	30.3	41.3	31.8	33.4	44.3	32.9	26.2	27.4
Moldova				31.0	36.0	45.5	26.0	32.0	29.3	20.6	31.5
Ukraine								34.6	34.2	32.5	33.8
Bosnia and Herzegovina									58.7	13.9	36.3
Albania					34.9	40.1	91.3	35.4	32.7	42.6	46.2
FYR Macedonia						66.1	59.5	50.3	62.6	46.5	57.0

*NPL levels reflect latest available data. In some cases (see references to Hungary, the Czech Republic, and Estonia below), data was not reported in the latest EBRD report. Thus, I relied on the most recently available report in which data was actually provided.

Sources: EBRD Transition Reports, 2002, 2003, 2004, 2005 (London: EBRD). Data for Hungary for 1993-96 comes from EBRD Transition Report, 2001. Data for Czech Republic for 1994 comes from EBRD Transition Report (1998). Data for Estonia and the Czech Republic for 1993 comes from Bert Scholtens (2000), "Financial regulation and financial system architecture in Central Europe," *Journal of Banking & Finance* 24 (525-553).

The seven-percent figure for Estonia appears especially stark when compared to the other three countries (Tables 3.2 and 3.3). Peak NPL numbers were immensely higher in Poland (24-36 percent), Slovakia (35-44 percent), and Ukraine (35-62 percent). Moreover, the latter three countries, unlike Estonia, experienced the worst of their NPL problems several years after the communist collapse (1992-93 in Poland, 1998 in Slovakia, and 1998 in Ukraine). The persistence and growth of soft loans over the course of the 1990s allowed budding political thugs to feed at the trough of state support for years and ultimately rise to the top of the business world. Figure 3.8 charts how the NPL problem unfolded over time in Estonia, Slovakia, and Poland.

Ukraine could not be included in Figure 3.8 because of the lack of quantitative data on the scale of NPLs during this period; data only became available beginning in 1999. However, the country clearly had a major NPL problem during its first post-communist decade. The very fact that NPLs accounted for 59 percent of all loans by 1999 indeed suggests that soft budget constraints in this area were rampant well before

Table 3.3. Peak NPL Levels in the Post-Communist Countries

Country	Peak NPL Year	Peak NPL (% of All Loans)
Estonia	1992	7
Croatia	1998	11
Czech	1996	18
Latvia	1995	20
Hungary	1991	23
Poland	1992	24
Albania	1994	27
Romania	1990	30
Lith	1995	32
Georgia	1991	33
Slovakia	1998	35
Russia	1998	40
Ukraine	1998	62
Macedonia	1993	70
Bulgaria	1996	75
Kyrgyzstan	1995	85

Source: Luc Laeven & Fabian Valencia (2008). "Systemic Banking Crises," IMF Working Papers 08/224, International Monetary Fund.

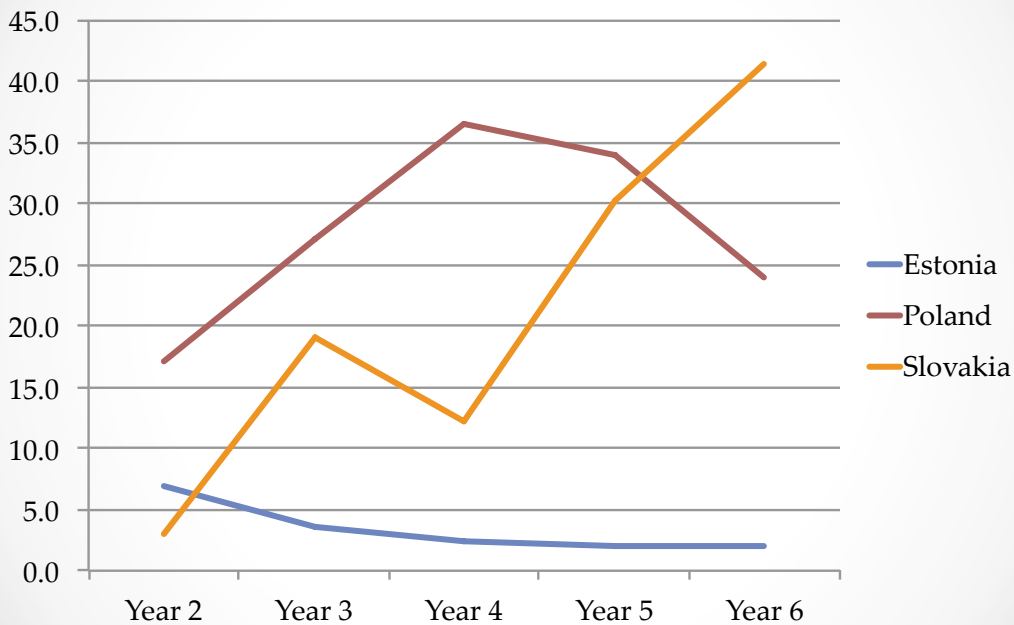
that point; unless the problem suddenly appeared only in that year, which is rather unlikely, the figure of 59 percent for 1999 likely indicates a large scale problem of bad loans through much of the 1990s (Table 3.2). Indeed, while the EBRD did not manage to put a specific number on Ukraine's pre-1999 NPLs, other specialists who studied the situation at the time did reveal substantial evidence that NPLs reached high levels during this period. Their findings will be examined in the chapter on Ukraine.

Now that the measures for hardness of budget constraints have been presented, we will turn to the methods used to operationalize the prevalence of political thugs among the plutocratic and non-plutocratic elites. The proportion of political thugs within the plutocratic elite can be measured simply by calculating the percentage of its ranks that scored their initial business success thanks only to their access to coercive resources. The data was obtained through a mix of sources. The first was in-depth interviews. Respondents were selected through a snowball-sampling procedure. They consisted mostly of journalists who have extensively covered the business actors under consideration. The second source used was print and online media investigations of the different business actors. Table 3.5 provides a breakdown of the plutocratic elites of all four countries according to actor-type.

The prevalence of political thugs among the non-plutocratic elite is much more difficult to measure. Two problems beset this effort. First, the community of all business actors among the non-plutocratic elite is very large and is not captured in published lists. This contrasts with the actors inside the plutocratic stratum, who appear on published lists and constitute a confined and countable group. Second, there is far less information available on the non-plutocratic elite than exists for the high-profile plutocrats. This might not apply to certain state officials who happen to get lots of media coverage. With few exceptions, though, most of the non-plutocratic elite tend to operate under the radar when compared to their plutocratic counterparts.

Figure 3.9. Non-Performing Loans Over Time

NPLs as % of all loans from Year 2 through Year 6 of the post-communist transition



An indicator that does provide some useful information is a country's overall level of investment as a percentage of GDP, averaged across all post-communist years. Most of the capital investment in a particular economy can be expected to come from entrepreneurs and crony capitalists – those business actors with the greatest proclivity to seek profit through investment. It is their access to capital, especially during the early stages of their careers, that define these types of business actor. Political thugs tend to be far more focused on deriving profits from siphoning and raiding rather than investment in productive activities. We should thus expect Estonia to come out well ahead of the other three countries in terms of its level of investment relative to GDP.

The numbers support this. The IMF publishes annual figures on investment as a percentage of GDP for all countries. When comparing this figure across countries, a question naturally arises as to what exactly constitutes a large or small difference; when investment accounts for 23 percent of GDP in one country and 20 percent in another, does this amount to a big difference or a minor difference? In order to provide an appropriate baseline for comparison, the post-communist countries are ranked against Korea. Korea exhibits the highest amount of investment relative to GDP among all advanced-industrialized economies (with the exception of tiny Malta). When indexed against Korea, Estonia emerges with among the highest levels of investment as a proportion of GDP in the entire post-communist region. Slovakia, Ukraine and Poland fall below Estonia in this regard (Table 3.4).

Table 3.4. Investment as a Share of GDP (Korea = 1)

<u>Country</u>	<u>1990-2010 (Avg.)</u>	<u>Index (Korea = 1)</u>	<u>% Difference from Korea</u>	<u>Rank</u>
Belarus	33.7	1.04	9%	1
Mongolia	32.9	1.02	5%	2
Moldova	30.4	0.94	-12%	3
Estonia	29.5	0.92	-18%	4
Czech Republic	28.5	0.89	-24%	5
Azerbaijan	27.8	0.86	-29%	6
Slovak Republic	27.3	0.85	-32%	7
Kazakhstan	26.9	0.84	-35%	8
Georgia	26.2	0.81	-39%	9
Bosnia and Herzegovina	26.1	0.81	-40%	10
Latvia	24.8	0.77	-48%	11
Romania	24.7	0.77	-49%	12
Slovenia	24.7	0.77	-49%	13
Uzbekistan	24.7	0.77	-49%	14
Albania	24.4	0.76	-51%	15
Armenia	24.3	0.75	-52%	16
Montenegro	24.2	0.75	-52%	17
Ukraine	23.8	0.74	-55%	18
Hungary	23.3	0.72	-58%	19
Croatia	22.7	0.70	-62%	20
Russia	22.4	0.70	-64%	21
Lithuania	21.9	0.68	-68%	22
Bulgaria	21.5	0.67	-70%	23
Poland	20.9	0.65	-74%	24
Kyrgyz Republic	19.5	0.61	-83%	25
Serbia	17.8	0.55	-94%	26
Tajikistan	16.9	0.52	-100%	27

Source: International Monetary Fund, World Economic Outlook Database
(<http://www.imf.org/external/pubs/ft/weo/2014/01/weodata/index.aspx>)

To be sure, this is hardly a perfect indicator. Even if they began their business careers without having much capital, many political thugs have over time managed to boost the amount of productive capital under their control simply by stealing it from the state or other business actors. A high level of investment relative to GDP can thus mask an underlying business environment marked by the dominance of political thugs.

However, aside from investment as a percentage of GDP, we can also examine the actual cases of non-plutocratic raiding that occurred and calculate the proportion of these perpetrated by political thugs. To be sure, this indicator only measures the probability that a business actor is a political thug given that he is a raider. What we are most interested in is the probability that an individual is a political thug given that he resides among the non-plutocratic elite. That said, if we can observe a high incidence of non-plutocratic raiding, and we can also observe that practically all raids for which sufficient information is available were committed by political thugs, then we can infer

by extension that there in fact is a high prevalence of political thugs among the non-plutocratic elite.

In all, I found 72 criminal corporate raids for which members of the non-plutocratic elite were responsible (see Tables 4.2, 5.2, 6.2, and 7.2). Of these, *at least* 40 – or 56 percent – were the work of political thugs. This number represents an absolute minimum; for most of the remaining 32 raids, I simply did not have enough information to infer whether the perpetrators were political thugs, crony capitalists, or entrepreneurs. If we only consider the 42 raids that did yield enough information in this regard, we can reasonably conclude that all but two – a whopping 95 percent – were committed by political thugs. If we assume that the figure for the 30 raids that lack sufficient data is roughly similar to the figure for the 42 we do have enough information on, this would mean that political thugs were responsible for practically all non-plutocratic raids documented in this study. What's more, my research in Poland, Slovakia, and Ukraine left me with the strong sense that I had barely scratched the surface of all raids that have ever taken place there. If that is true, and if most of the raids I did *not* find were likewise the work of political thugs, this would suggest that political thugs in these countries have a widespread presence indeed. To be sure, these inferences assume that the sample of raids for which I have enough data is actually representative of the sample for which I lack sufficient data. It further assumes that the entire sample of raids I found is in turn representative of the general population of raids. But I see no reason to believe otherwise.

In addition, one of the key hypotheses of this study predicts criminal corporate raiders to come mostly from the ranks of political thugs as opposed to crony capitalists or entrepreneurs. If we are able to observe that most raiders are, in fact, political thugs, this hypothesis would be confirmed. If the majority of raiders belong to the other two categories, it would be falsified. Examining just how often raids by the non-plutocratic elite were initiated by political thugs enables us to test this hypothesis.

Obviously, this is a highly imperfect indicator. But as the enormous pile of case studies will make abundantly clear, political thugs show up time and again among the non-plutocratic elites of Poland, Slovakia, and Ukraine. In Estonia, they are very hard to find; while there are plenty of examples of low-level criminals trying to steal assets through document forgery, hardly any of these individuals come close to approximating wealthy business elites. There are exceptions to this rule, but the point is that they are exceptions and not the rule. In the other three countries, political thugs are mainstream; they are prominently represented on the boards of the biggest and most well-known companies as well as important state positions. Furthermore, I concluded my research with the strong suspicion that the case studies I found there barely scratch the surface of the dark reality underneath. Had I spent another six months investigating these countries, I could have surely discovered more and more examples of political thugs (and crony capitalists). The situation in Estonia is far different. There, I began to hear the same stories from my respondents again and again as my research progressed.

Aside from political thugs, we must also assess the relative presence or absence of crony capitalists in both the plutocratic and non-plutocratic elites. For the plutocratic elite, it is relatively simple since we have a concrete list of individuals to examine. However, in the case of the non-plutocratic elite we run into the same problems as outlined above.

Nevertheless, if we observe a large share of crony capitalists among the plutocratic elite, it is reasonable to assume that there exists a substantial number of crony capitalists in the non-plutocratic elite as well. Once again, this is an imperfect indicator. But it is not as flawed as one might think. Take a country like Poland, where crony capitalists make up a large proportion of the plutocratic elite. These individuals represent the few who managed to make it into the ranks of the super-wealthy. It would be quite amazing indeed if *these* crony capitalists happened to be the *only* crony capitalists in Poland – as if *all* the crony capitalists there were lucky enough to make it into the ultra-wealthy stratum. Surely, the crony capitalists who ended up as members of the plutocrats can be expected to represent the tip of the iceberg in terms of the overall number of crony capitalists in the country. The same is true of political thugs; unless the political thugs in the plutocratic elite are the only political thugs in the country – again, a very unlikely proposition – then a high percentage of political thugs among the plutocrats should indicate a substantial presence of such actors in the non-plutocratic elite as well.

To be sure, the reverse proposition – that a high percentage of *non-plutocratic* crony capitalists and political thugs implies a high percentage of *plutocratic* crony capitalists and political thugs – would not necessarily be true. This, in fact, is one of the main findings of the study. Poland, in particular, has a non-plutocratic elite that is filled with political thugs and yet exhibits substantially fewer such actors among its plutocratic elite. After all, it takes some very special circumstances for a run-of-the-mill political thug to make it into the plutocratic stratum and it is hardly inevitable that even any will manage to pull off the feat.

But the opposite prediction – that a significant presence of political thugs and/or crony capitalists in the plutocratic elite implies a large share of such individuals in the non-plutocratic elite – is indeed a reasonable inference to make. It does not mean that the two proportions are equal or even roughly equal. It merely implies that the presence of these actors is *substantial*. And that is all we need to know. For the variable we are trying to measure is not continuous but rather discrete; as long as networks of political thugs and crony capitalists are extensive – a yes-or-no proposition – then property rights institutions have little chance of becoming truly authoritative.

Table 3.5 contains a breakdown of each country's plutocratic elite by actor-type. It reveals some sharp differences. Two numbers stand out as particularly important. The first is the percentage of a given country's plutocrats that is made up of political thugs. This is the key immediate determinant of variations in the frequency of plutocratic raiding. Here, the main difference is between Ukraine and Slovakia, on the one hand, and Poland and Estonia, on the other. The proportion of the plutocratic elite comprised of political thugs ranges from 53 to 65 percent in Ukraine and 71 to 77 percent in Slovakia. By contrast, in Poland they make up 28 to 36 percent while the corresponding numbers for Estonia are 26 to 32 percent.

The second figure of note is the combined percentage of political thugs and crony capitalists; it is this that is most relevant to the prospect that authoritative property rights institutions can develop in a given country. While 42 to 53 percent of Estonia's plutocrats belong to these two categories, the numbers for Poland are higher (56 to 69 percent). They make up an even greater proportion in Ukraine (83 to 98 percent) and Slovakia (77 to 88 percent).

Table 3.5. The Plutocratic Elite: Actor-Types (by Country)

Actor Type	Ukraine	Slovakia	Poland	Estonia
Entrepreneurs	2.5% to 5.0%	11.8% to 17.6%	30.8% to 35.9%	47.4% to 57.9%
Crony Capitalists	30.0% to 45.0%	5.9% to 17.6%	28.2% to 41.0%	15.8% to 26.3%
Political Thugs	52.5% to 65.0%	70.6% to 76.5%	28.2% to 35.9%	26.3% to 31.6%
Cronies & Thugs Combined	82.5% to 97.5%	76.5% to 88.2%	56.4% to 69.2%	42.1% to 52.6%
Cronies & Entreps Combined	32.5% to 47.5%	17.7% to 29.4%	59.0% to 71.8%	63.2% to 73.7%

It should be noted here that Poland seems to fall in the middle; while the combined presence of political thugs and crony capitalists is higher than Estonia, it is not nearly as great as in Ukraine and Slovakia. Would this not predict that Poland's property rights institutions be more effective than they are? Not when one considers how ubiquitous these criminal actors are among the non-plutocratic elite. Whatever slight advantage accrues to Poland by virtue of the lower combined percentage of *plutocratic* political thugs and crony capitalists is trumped by the dense and powerful networks they form in the *non-plutocratic* stratum. So long as they have a dominant presence in either stratum, they will do whatever is necessary to cultivate corrupt patrons throughout the state apparatus. The existence of these corrupt officials will subsequently impede the establishment of effective, legally-enforced rules in the sphere of property rights.

A final word is in order as to how we are to determine whether a given business actor qualifies as a political thug, a crony capitalist, or an entrepreneur. Particularly with regard to the former two types, the waters can appear muddied. Some individuals literally stole their first million – or \$10 million – but then turned it into a profitable business enterprise. Should they be considered political thugs or crony capitalists?

This study will differentiate the two in the following way. Both types may have gotten their start through soft budget constraints or other kinds of political favors. The crony capitalist, however, turned the very resources obtained by such means into a value-producing concern. The political thug failed to do so; whatever business enterprise he or she established could not survive without the continual flow soft budget constraints, whether tax breaks, subsidies, or soft financing.

Even if that individual subsequently went on to create a new business that did generate economic value, as some did, she will still be considered a political thug to the extent that the later business was substantially separate from the first. The key is whether her *first* profitable business enterprise depended on the continuation of soft budget constraints or instead developed a capacity to survive without externally-provided largesse.

What specific indicators allow us to determine whether a given business actor is a crony capitalist as opposed to a political thug? How can we tell if someone should instead be labeled an entrepreneur? Applying hard-and-fast rules to all cases would be inappropriate. But there are a number of indicators that can aid in this task. Some of these are rather clear-cut. One telltale sign of a political thug arises when the individual has undertaken most if not all of her business activities while serving in a state position. Because there is very little likelihood that these activities involved any real capital investment, we can rule out the idea that she is a crony capitalist (much less an entrepreneur). Likewise, if a businessman started out running criminal protection rackets, this qualifies him as a political thug.

If the person in question rose to wealth on the back of a fraudulent privatization, that too is indicative of a political thug. If, however, she went on to invest substantial capital into improving the enterprise, this would make her a crony capitalist. Another sign that she is a crony capitalist as opposed to a political thug is if the privatized enterprise belongs to a sector of the economy that requires continual investment and innovation to remain competitive. If the individual still managed to earn considerable wealth from owning the company and did so over a long period of time, this only could have come about from significant and ongoing capital investment – the hallmark of a crony capitalist.

An example is Ukraine's Vyacheslav Boguslayev, a typical "red director" and close ally of Leonid Kuchma who privatized Zaporizhya Motors within days of the latter's election as President in 1994. Renamed Motor Sich in 1995, it would become a successful manufacturer of aircraft parts and earn Boguslayev hundreds of millions of dollars.²⁴ Selling airplane engines competitively requires continuous investment in new and better technologies. Clearly, then, Boguslayev should be considered a crony capitalist and not a political thug.

When an individual's early success came as a result of a questionable state contract, this also suggests that he is a political thug. Polish billionaire Zygmunt Solorz is a good example. In 1994, his television station, Polsat, was awarded the country's first private broadcasting license for approximately \$10 million. It received the license despite the fact that several prominent and far better-capitalized foreign providers submitted higher bids. At the time, Solorz was a relatively small-time businessman. So where did he get the money? He just cannot remember.²⁵

If a businessperson collaborated with the communist or post-communist secret services, this was typically a sign that political connections would play a role in his early success. While it does not allow us to determine if he is a political thug or crony capitalist, it generally excludes the possibility that he is an entrepreneur. An exception arises when the individual went on to create an unquestionably innovative product or service. This could indeed signal that he is an entrepreneur, especially if the business did not obviously benefit from his prior role as an intelligence agent and could clearly succeed in a competitive marketplace without political favors.

Polish plutocrat Leszek Czarnecki exemplifies this type of entrepreneur. Czarnecki was an agent of the secret police during the 1980s. But this evidently played no role in his later business success, which is widely regarded to have resulted from his incredible intellect and intuition. His first major score came in 2001 when he sold the European Leasing Fund to France's *Crédit Agricole* for €400 million. He had created the firm ten years earlier as the first consumer finance company in Poland. After selling it he proceeded to found and take public a number of other successful financial firms such as

²⁴ Andrei Samofalov, "Chelovek s Motorom: Biznes-Istoria Viacheslava Boguslaeva," *Forbes Ukraina*, 19 August 2013

²⁵ Interview with Jacek Łęski, 8 April 2008; Jan Cienski, "The Biggest Gamble for a Habitual Risk-Taker." *Financial Times*, 7 December 2005; Wojciech Wybranowski, submission to *Afery Prawa*, 26 October 2010 (<http://www.aferyprawa.eu/Afery/Solorz-Zak-Zegarek-i-jeszcze-kilka-nazwisk-wlasciciela-platformy-POLSAT-agenta-SB-Zygmunt-Solorz-Zak-o-przkretach-aferyzisty-Zawiadomienie-CBA-ministra-Mariusza-Kaminskiego-1194>).

Getin Bank and Noble Bank. In 2004 the *Financial Times* recognized Czarnecki as one of the 25 rising stars of European business. He was the only Pole to make the list.²⁶

Czarnecki's career reveals another indicator that helps us rule out the possibility that a given business actor is a political thug. Certain people created their businesses from scratch and then managed to sell them to foreign investors or successfully list them on major stock exchanges. This is a sign that the individual in question created something of real economic value. If that person's early career was also marked by corruption scandals, the receipt of soft budget constraints, or past collaboration with the secret services, it suggests that she is a crony capitalist. Otherwise, she can be labeled an entrepreneur.

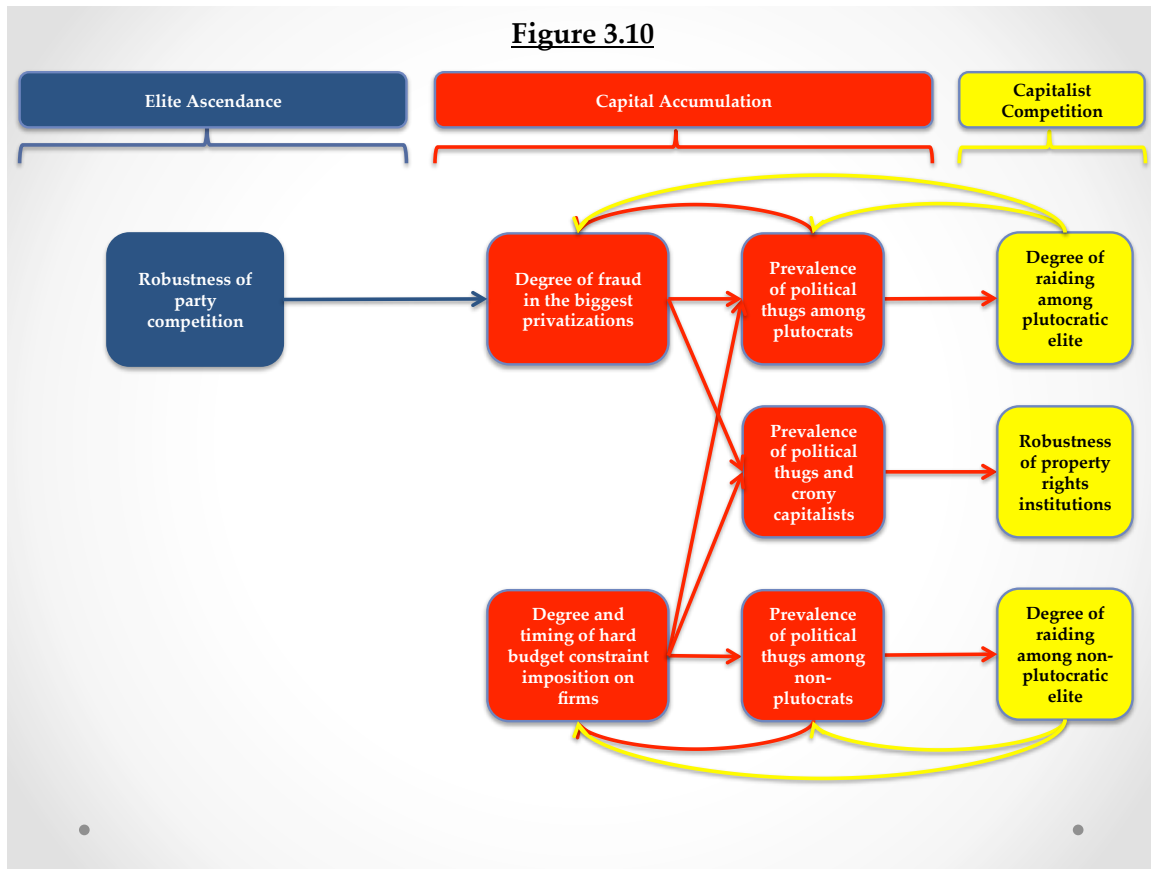
When a businessman is involved in economic sectors that are highly politicized, this usually excludes the possibility that he is an entrepreneur. The particular sectors that merit this distinction can often vary by country. But areas such as construction, real estate development, pharmaceuticals, energy and other natural resources, and the production and sale of arms require myriad permits, approvals, or contracts from the state. In many (but not all) countries, obtaining these concessions necessitates the payment of bribes or, at a minimum, the careful cultivation of political contacts. However, while participation in politicized sectors is usually enough to prevent one's designation as an entrepreneur, it does not always indicate whether he is a political thug or crony capitalist (unless, as noted above, the nature of the industry requires continual capital investments in upgrading production processes). Making that distinction can require the presence of additional indicators of the kind mentioned earlier.

Among the plutocratic elite, I was usually able to determine with some certainty whether a given individual is a political thug, a crony capitalist, or an entrepreneur. In some cases I could not find sufficient information to make the designation. But these were exceptions. And in almost all such instances I was able to rule out at least one category; typically, these actors are labeled as either crony capitalists or political thugs or, alternatively, either crony capitalists or entrepreneurs. There were only two individuals – Estonian businessmen Raul Kirjanen and Toomas Tamm – for whom I simply could not find enough data to rule out any of the three categories. The uncertain cases are noted in the four country chapters, each of which contains a table listing all of the plutocrats along with their designated types. For the non-plutocratic elite, the amount of information available was necessarily inferior when compared to the plutocrats. In a number of cases, I could not find enough information to suggest whether a business actor is a political thug or instead qualifies as one of the other two types. These instances are likewise noted in the relevant tables.

Elite Ascendance: Defining the Causal Variables

Earlier, we saw how soft budget constraints led to the rise of powerful networks of political thugs and crony capitalists while hard budget constraints could avert this scenario. However, a policy of hard budget constraints did not come out of nowhere. Three additional ones influenced the prospects it would be adopted. All relate to the elite

²⁶ Piotr Nisztor, "Leszek Czarnecki w Służbie Sb," *Rzeczpospolita*, 1 July 2008; Aleksandra Biały, "Leszek Czarnecki - Arogant z Intuicją," *Rzeczpospolita*, 30 November 2007; "Leszek Czarnecki, Czyli Miliarder Pod Wodą," *Polska Times*, 7 May 2008.



actors who ascended to power during the transition from communist rule and the nature of competition among these actors.

The first was the robustness of party competition (Figure 3.10). A number of scholars have pointed to the role of strong party competition in constraining corruption.²⁷ This study finds it did play a key role in restraining privatization fraud. Governments that confronted a vigorous parliamentary opposition had a clear incentive to refrain from this most blatant and visible form of illicit soft budget constraint. In particular, where opposition parties were sufficiently strong, they were able to force ruling parties to agree to the creation of national accounting offices with broad powers to audit government expenditures and revenues. To the extent that privatizations directly impact the revenue side of the state budget, effective national accounting offices would examine them as well. Such bodies arose in Poland and Estonia and acted to deter successive governments from engaging in overt privatization fraud, especially in the most high-profile sales. That said, when it came to other kinds of soft budget constraints (whether licit or illicit), robust party competition evidently failed to make much of an impact. After all, Poland saw an explosion in informal tunneling and public procurement corruption despite the strong competition that characterized its party system.

In Slovakia and Ukraine, governments faced scant monitoring from other parties and little threat of removal. Consequently, national accounting offices along with other mechanisms of parliamentary control over the executive proved to be weak and

²⁷ Grzymala-Busse; O'Dwyer.

politicized. This enabled ruling factions to preside over rampant fraud in the privatization process. They often enhanced their capacity to do so by placing restrictions on electoral competition, the legislative and judicial branches, civil society, and the media. (But the active repression of opposition parties is not a precondition for a fraudulent privatization process. As the experience of the Czech Republic shows, all that is required are weak, disorganized parliamentary oppositions incapable of holding the government to account.)²⁸

As a result, robust party competition only managed to stem one particular form of illicit soft budget constraint: soft subsidies in the form of underpriced formal privatizations. Nevertheless, while strong party competition determined how corrupt the privatization process was overall, the most important facet of privatization fraud for our purposes was its prevalence in the very biggest sales. As noted above, political thugs tended to lack the capital necessary to win fairly-conducted privatizations. That said, in many instances they had already amassed substantial amounts of capital thanks to other forms of soft budget constraints (like overpriced state contracts and the tunneling of state enterprises). As a result, they often could and did win honest privatizations when the companies being sold were relatively modest in size and value. However, except in very rare cases, they did not meet the very large capital requirements to successfully compete in the biggest privatizations. Thus, while the strength of party competition influenced the scale of fraud in the overall privatization process, it was the privatizations of the biggest state firms that mattered most in this study.

Aside from party competition, two additional factors would influence the implementation of hard budget constraints in general. First and foremost was whether or not revolutionaries, as opposed to ex-communists or radical ethno-nationalists assumed power in the early post-communist period (Figure 3.11). The survival in power of former communists tended to give way to a new order marked by the frivolous and abundant provision of external support to inefficient economic actors.

To understand why, it is necessary to peer into the particular mentality of the nomenklatura in the late-communist era, a ruling elite known for its special appetite for graft.²⁹ Underlying this propensity was a peculiar self-conception most eloquently described by Ken Jowitt:

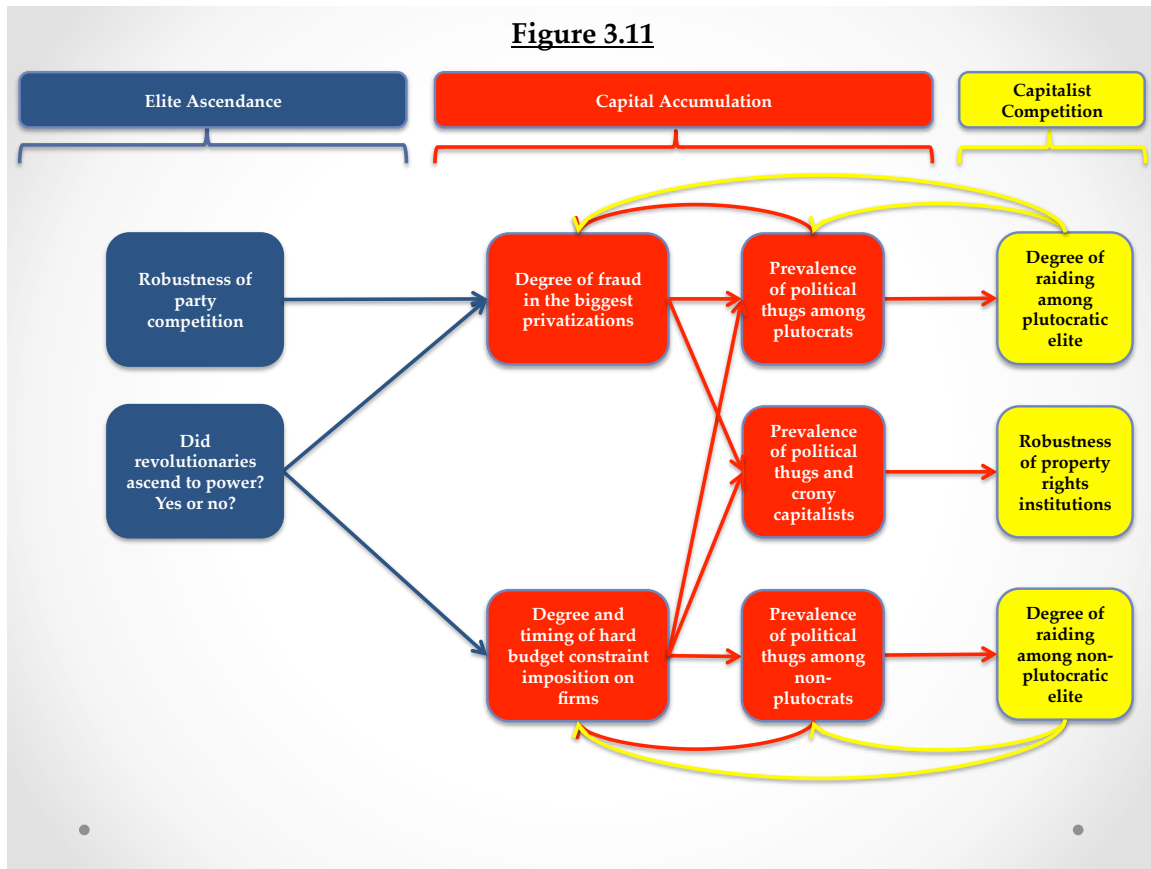
Brezhnev's rule absolutized apparat/cadre citizenship and answered Jerry Hough, who in light of the apparat's internal differentiation and complexity asked: "On what questions are the first secretaries dogmatically agreed on the nature of the answers?" The answer was: on their superior and exclusive political status.³⁰

To Jowitt, members of the nomenklatura regarded themselves as a superior breed, a status that naturally entitled them to a charmed and privileged existence at public expense. In their eyes, the exclusive standing they enjoyed afforded them the right to treat the

²⁸ On corruption in the Czech privatization process, see Schwartz; Appel, "Corruption and the Collapse of the Czech Transition Miracle." On the weakness of party competition in the Czech Republic, see Grzymała-Busse.

²⁹ Hedrick Smith, *The Russians* (New York: Ballantine Books, 1976), 25-52, 81-101.

³⁰ Jowitt, *New World Disorder: The Leninist Extinction*, 223.



economy as a source of tribute, booty, and plunder.³¹ Importantly, most communist regimes enforced limits, however broadly, on the ability of officials to steal. Once this regime disappeared, well, the party was on. All manner of illicit soft budget constraints flourished, ranging from fraudulent public procurement contracts to input-output schemes that bankrupted state enterprises to loans issued with no intention whatsoever of repayment.

In addition to illicit soft budget constraints, however, the survival in power of ex-communists created powerful tendencies for the persistence of more above-board forms of state support to firms. The most important political constituency for ex-communists who found themselves in power after the transition was their ex-communist colleagues in charge of state-owned enterprises. The new post-communist leadership was hardly in a position to alienate this crucial constituency by cutting them off from the flow of cheap loans and subsidies. This was especially true given the economic crisis that prevailed in virtually all of these countries at the time. Where the former nomenklatura held onto power, they would act to preserve soft budget constraints. In doing so they would pave the way for the rise of political thugs and marginalization of entrepreneurs.

Clearly, a functioning system of legal property rights protections required that the nomenklatura be forced from power. Scholars have devoted much attention to the “communist exit,” or the degree to which this ruling elite experienced political defeat during the transition from communist rule. Electorates in Czechoslovakia, Poland,

³¹ Ibid., 224.

Hungary, and the Baltic states completely ousted the communists at the first opportunity. In other countries, such as Russia and Ukraine, the nomenklatura managed to maintain its hold on power even as the communist regime itself collapsed around it. Many scholars have argued that the degree to which the communists exited from power following the first free elections was especially crucial in determining the likelihood that democratic regimes and viable market economies would emerge.³²

The degree to which the communists fell from power was surely important. But it was not the whole story. Democracy and radical market reform did indeed follow the defeat of communists in much of East-Central Europe and the Baltic states. But the communists were also forced from power in Croatia, Bosnia-Herzegovina, Georgia, Armenia, and Moldova. And what subsequently arose in these latter places was not democracy and market reform but populist dictatorships that marched their societies into ethnic war. Clearly, what mattered was not the scale of the communist exit *per se* but rather the character of the political oppositions that replaced them.³³

Anti-communist opposition movements took two starkly different forms. The first espoused revolutionary ideologies bent on radically transforming communist regimes into democratic ones and command economies into free markets. Revolutionaries swept to power during the transition from communist rule in Czechoslovakia, Poland, Hungary, Estonia, Latvia, and Lithuania. Their agendas were revolutionary to the extent that they rejected the incremental approach of conventional reform in favor of tackling all outstanding issues in one fell swoop. For post-communist revolutionaries, a step-by-step approach, addressing political change first and economic transformation later, would not suffice.³⁴ In their eyes, the problems besetting the defunct communist model were interlocking and mutually reinforcing. Resolving them would thus require rapid and simultaneous change at all levels – political, economic, and societal. In short, it would take not reform but a *revolution* to lift these societies out of the mangled institutional mess of communism and into the welcoming arms of Western modernity.³⁵

Why, on the whole, was it revolutionaries rather than reformists who would spearhead the transformation toward a market economy? The introductory chapter put forth the hypothesis that the rise to power of either type of movement can successfully bring about major institutional change. Nevertheless, in most of Eastern Europe and the former Soviet Union, the very nature of the communist system rendered traditional reformism both unviable and irrelevant to proponents of change. Communism consisted not only of a distinctive economic arrangement (the command economy) but a unique

³² See, for example, Keith Darden and Anna Grzymala-Busse, "The Great Divide: Literacy, Nationalism, and the Communist Collapse," *World Politics* 69, no. 1 (2006); Fish, "The Determinants of Economic Reform in the Post-Communist World."; Hanley, "Cadre Capitalism in Hungary and Poland: Property Accumulation among Communist-Era Elites."; Jørgen Møller and Svend-Erik Skaaning, "The Three Worlds of Post-Communism: Revisiting Deep and Proximate Explanations," *Democratization* 16, no. 2 (2009).

³³ Bunce does address the character of these oppositions, distinguishing between "liberal regimes-in-waiting" and "illiberal regimes-in-waiting" that variously rose up and toppled the communists from power during the transition from communist rule. See Valerie Bunce, "The Political Economy of Postsocialism," *Slavic Review* 58, no. 4 (1999).

³⁴ On the difference between revolutionary and reformist change, see Jowitt, *Revolutionary Breakthroughs and National Development: The Case of Romania, 1944-1965*.

³⁵ Bunce, "The Political Economy of Postsocialism."

political regime (the Communist Party's monopoly on power) and system of social stratification (a privileged nomenklatura atop an otherwise classless society). As a result, when genuine movements for change emerged in the late 1980s, they would not be satisfied with a step-by-step approach, tackling one set of problems before moving onto another. They rather saw the one-party state, command economy, and privileged nomenklatura as mutually-interdependent problems. These issues had to be addressed simultaneously rather than piecemeal.

Recall Skocpol's famous definition of a social revolution as one in which "basic changes in social structure and in political structure occur together in a mutually-reinforcing fashion...through intense sociopolitical conflicts in which class struggles play a key role."³⁶ Where fundamental change did take place in the post-communist world, it tended to occur precisely through the kind of social revolution Skocpol had in mind.³⁷

The one exception was Slovenia. There, a genuine market transformation did take place but through reformist rather than revolutionary means. The reason for this was the peculiar structure of the communist-era Yugoslav economy. Unlike other communist countries, central planning was discarded in Yugoslavia from 1965 onward and economic decision-making was delegated to the enterprise level. Moreover, state-owned firms were given wide scope to trade with Western countries and enjoyed a certain degree of price flexibility as well. All of these factors made the Yugoslav (and Slovene) economy much more competitive than those of other communist countries and thus free from the chronic shortages that beset them.³⁸

Slovenia did experience a rapidly accelerating economic crisis during the late 1980s, thanks mostly to hyperinflation. The crisis put market reform squarely on the political agenda. However, because Slovenia lacked a command economy under the exclusive control of a privileged nomenklatura and had competitive firms, calls for revolutionary as opposed to reformist change did not assume as prominent a role. The DEMOS coalition that won the first free elections in March of 1991 indeed insisted on the rapid implementation of market reforms. But many in Slovenia did not share this same sense of revolutionary urgency; in particular, while most Slovenes supported monetary reform and macroeconomic stabilization, privatization and restructuring was considered by many to be a lesser priority. This helped give rise to a powerful center-left opposition in the first parliament that succeeded in blocking privatization.³⁹

The defining characteristic of the revolutionary agenda is the perception that prevailing problems are mutually reinforcing and must therefore all be addressed at once. But Slovenia witnessed exactly the kind of step-by-step, gradual move toward the market that typifies the reformist approach to change. To this extent, Slovenia stood in marked contrast to Poland, Hungary, Czechoslovakia, and the Baltic states. There were other governments besides Slovenia's that adopted the mantra of "gradualist reform." Where invoked, however, it usually tended to serve as an expedient rhetorical device to legitimize crony capitalism (as in Ukraine).

³⁶ Skocpol, 5.

³⁷ That is, leaving aside the violence that Skocpol sees as fundamental to any social revolution. By and large, violence did not accompany these post-communist revolutions.

³⁸ Boris Pleskovic and Jeffrey D. Sachs, "Political Independence and Economic Reform in Slovenia," in *The Transition in Eastern Europe, Volume 1*, ed. Olivier Jean Blanchard, Kenneth A. Froot, and Jeffrey D. Sachs (Chicago: University of Chicago, 1994), 192-93.

³⁹ *Ibid.*, 194-99.

The ouster of the former communist elite created a momentous opportunity for revolutionaries to take their place. But in Croatia, Bosnia-Herzegovina, Moldova, Georgia, Armenia, and Azerbaijan,⁴⁰ the struggle to succeed the communists was won not by revolutionaries but *ethno-nationalists*. If the ideological centerpiece of the revolutionary parties consisted of radical political and economic change, for ethno-nationalists this was, if anything, a sideshow. Instead, their main motivation was radical ethno-nationalism. This ideology combined a fear of domination by neighboring ethnic groups with a strong desire to avenge past grievances suffered at the hands of these groups.

Needless to say, the ascendance of populist ethno-nationalists did not bode well for the prospect that effective and efficient property rights institutions would emerge. Most importantly, where ethno-nationalist leaders came to power they invariably chose not to impose hard budget constraints on economic actors (Figure 3.11). This issue simply did not rank as a major priority when compared to their ethno-nationalist goals. As a result, the stage would be set for political thugs to swell in wealth and power on the back of soft budget constraints.⁴¹

However, while a necessary condition, the mere rise to power of a revolutionary government was not sufficient to avoid a trajectory of rampant criminal corporate raiding. As discussed above, the new government had also to impose comprehensive and immediate hard budget constraints upon economic actors. It is precisely here where individual agency enters into the analysis, albeit to varying degrees depending on the types of leaders that would emerge predominant. A government of ex-communists, by virtue of its dependence for support on ties to the former establishment still at the helm of state enterprises, could not implement hard budget constraints. A government of ethno-nationalists would not take such radical steps, though it theoretically could since it was not as reliant on the former nomenklatura for political support (at least initially). As we will see, not all revolutionary governments did so either. In fact, your correspondent knows of only one that really implemented such measures to the fullest extent required, and that was the government led by the Pro Patria party in Estonia. However, even though many revolutionary leaderships did not carry out these policies, for them it was much more a matter of choice than it was for the other two types. Revolutionaries were far freer to implement hard budget constraints than were governments dominated either by ethno-nationalists or the former nomenklatura. In this respect, the scope for elite agency varied according to the influence of ex-communists and ethno-nationalists in the first post-communist government; the lesser their influence, the greater choice leaders had in adopting hard budget constraints.

Thus, the ascendance of revolutionaries to power was a precondition for the imposition of hard budget constraints but hardly ensured it would happen. Revolutionaries, once in power, had to make the right choices. And to make the right choices they had to possess the right beliefs about the predicament in which their

⁴⁰ In Azerbaijan, the communists did not lose power in a formal sense during the transition. However, if they maintained control over the formal reins of power they most certainly lost control of the political agenda, which by and large came to be shaped by radical ethno-nationalist movements, most notably the Azerbaijani Popular Front. See Stuart J. Kaufman, *Modern Hatreds: The Symbolic Politics of Ethnic War* (Ithaca, NY: Cornell, 2001), 167-74.

⁴¹ On Croatia under Tudjman, for instance, see Damir Grubiša, "Political Corruption in Transitional Croatia: The Peculiarities of a Model," *Politička misao* XLII, no. 5 (2005).

countries found themselves. Even some of the most ardently neoliberal governments in the region, such as that led by the Civic Democratic Party (ODS) in Czechoslovakia, continued propping up state banks and financial intermediaries in the belief that the really crucial task at hand was privatization.⁴² Why was the ostensibly radical ODS government so preoccupied with privatization that it could actually countenance the continuation of soft budget constraints? Why was the Pro Patria-led coalition in Estonia not so preoccupied? The reasons are idiosyncratic, not structural; they relate to the particular beliefs and priorities held by key members of these coalitions.

One may question the assertion that the decision to harden budget constraints was not affected by any other structural determinants besides the ones highlighted here (the rise of revolutionaries and the mode of transition). For instance, some countries were burdened with a greater legacy of heavy industry than others. The prospect of additional mass unemployment may have constrained governments in those countries from implementing hard budget constraints. Table 3.6 ranks countries according to the energy-intensiveness of their respective economies. While Estonia's economy is less energy-intensive than the other three, it hardly stands out in this regard when compared to all post-communist countries; indeed, its heavy-industry burden was far more substantial than most and yet it still managed to go as far as it did in hardening budget constraints.

Clearly, Estonia's early post-communist leaders were "stretching their constraints," to use a term from George Breslauer's study on leadership;⁴³ rather than passively following the script history offered up to them, they were, if anything, breaking it. For countries where revolutionaries had taken power through a process of replacement, whether or not governments imposed hard budget constraints was mostly a matter of the beliefs, priorities, initiative, and skills of their leaders. While the possible role of other structural factors cannot be ruled out, leadership goes a long way in explaining why Estonia's elites did it while Slovakia's – who likewise were revolutionaries and assumed power through replacement – did not.

The seizure of power by revolutionary parties was thus essential in order to prevent the large-scale distribution of soft budget constraints. In this way, the avoidance of soft budget constraints initially required an *imbalance* of power in favor of revolutionaries and at the expense of ex-communists and ethno-nationalists. However, the importance of party competition highlights a subtle shift that had to subsequently occur if blatant privatization fraud was to be averted. After the initial transition, the best chances for preventing corruption in the privatization process occurred where there was a *rebalancing* in the strength of rival political parties. Many revolutionary parties, once in power, would try to get away with giving their supporters as many soft budget constraints as they could, including but not limited to underpriced privatizations. But privatization fraud (if not other kinds of soft budget constraints) could be stopped if there arose a strong parliamentary opposition to check the government's actions.

As Grzymała-Busse argues, the countries with the best chances for such a rebalancing of power to occur were those in which the former communist parties reformed themselves into West European-style social democratic parties following their ejection from power. According to her, ousted communist parties regenerated themselves

⁴² For a discussion of the continued provision of soft budget constraints to state banks and IPFs, see Gould, 81-89.

⁴³ Breslauer, *Gorbachev and Yeltsin as Leaders*.

Table 3.6. Energy Intensity

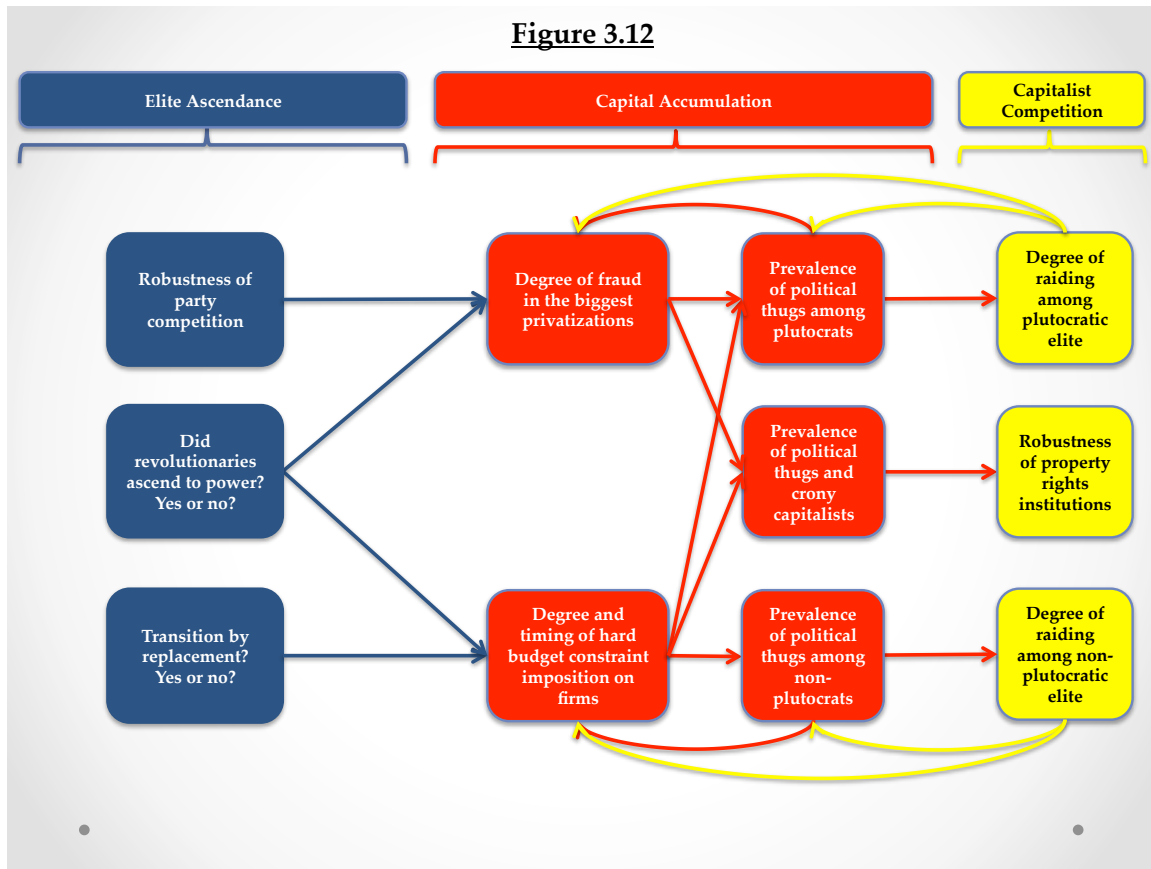
<u>Country</u>	<u>Energy use (kg of oil equivalent per capita)</u>	<u>Industry, value added (% of GDP)</u>	<u>Energy Intensity</u>	<u>Year</u>
Slovak Republic	4024.7	59.1	4.20158E-06	1990
Russian Federation	5351.2	43.0	4.34514E-06	1992
Ukraine	4210.4	50.9	4.66524E-06	1992
Kazakhstan	4796.1	44.6	4.67574E-06	1992
Czech Republic	4797.1	40.2	5.18415E-06	1990
Belarus	3620.7	47.8	5.78042E-06	1992
Bulgaria	3236.1	49.2	6.28127E-06	1990
Poland	2705.4	50.1	7.37646E-06	1990
Estonia	4282.7	30.4	7.68075E-06	1992
Lithuania	2978.5	42.9	7.83348E-06	1992
Slovenia	2857.6	42.4	8.24749E-06	1990
Latvia	2335.4	34.9	1.22783E-05	1992
Uzbekistan	2110.5	35.8	1.3233E-05	1992
Hungary	2419.7	31.2	1.32672E-05	1990
Croatia	1888.3	35.8	1.4813E-05	1990
Mongolia	1560.5	42.5	1.50855E-05	1990
Moldova	1845.8	31.5	1.72066E-05	1992
Macedonia, FYR	1232.8	44.5	1.82312E-05	1990
Armenia	1197.4	39.4	2.11953E-05	1992
Georgia	1776.8	23.9	2.35066E-05	1990
Kyrgyz Republic	1102.7	37.8	2.39975E-05	1992
Tajikistan	750.1	46.1	2.89458E-05	1992
Turkmenistan	2674.6	11.9	3.14539E-05	1992
Albania	540.8	42.7	4.33051E-05	1991

Source: World Bank, World Development Indicators 2013. Methodology and concept for the indicator comes from Pop-Eleches (2007), 912-13

in this manner in only four countries: Hungary, Lithuania, Poland, and Slovenia. Estonia is an outlier to the extent that its communist party did not survive in any workable form into the post-communist era. Yet its party system has consistently been marked by robust competition. In Estonia, it was the Center Party of Edgar Savisaar that stood in for the role typically played by regenerated communist parties, as Grzymała-Busse points out. It would hold the reins of government for itself but would nonetheless serve as a perennial threat to whichever party did find itself in charge.⁴⁴ The reasons behind this unique development will be considered in chapter seven.

If the ascendance of revolutionaries and the subsequent choices they made were important, so was the particular mode by which they came to power (Figure 3.12).

⁴⁴ Grzymała-Busse, 14, 61-63.



During the 1980s the “transitology” school famously distinguished between three general modes of transition from authoritarian rule: elite-led imposition, negotiated pacts, and replacement. The outcome they sought to explain was not the emergence of robust property rights institutions but rather the type of political regime that established itself, whether democracy, authoritarianism, or a mix between the two. In some countries, the old elite itself led the way in forging the new regime (elite-led imposition). In other countries, oppositions arose, unseated the elites (whether peacefully or by force), and installed new regimes (replacement). In still other places, regime change occurred through a negotiated pact between the ruling elite and the opposition.⁴⁵

The transitologists indeed had the right answer – but to the wrong question. Their framework cannot explain variations in regime type, at least in the post-communist region. There, successful democratization proceeded through peaceful opposition replacement in Czechoslovakia and the Baltic states, elite-led imposition in Mongolia and

⁴⁵ Samuel P. Huntington, *The Third Wave: Democratization in the Late 20th Century* (Norman, OK: University of Oklahoma, 1991); Terry Lynn Karl and Philippe Schmitter, “Modes of Transition in Latin America, Southern and Eastern Europe,” *International Social Science Journal* 128, no. 2 (1991). I’m changing the terminology slightly. Huntington distinguishes between “transformation” (what I’m calling elite-led imposition), replacement, and “transplacement” (what I’m referring to as transition by negotiated pact). Karl & Schmitter identify four types of transition depending on whether the impetus for change came from elites or masses and whether it was carried out by compromise or force. For Karl & Schmitter, elite-led change could take the form of “pacts” between regime and opposition or “imposition” by the regime. Mass-led change could take the form of “revolution,” in which the masses replaced the regime by force, or “reform,” which proceeded by compromise.

Bulgaria, and negotiated pact in Poland and Hungary. The fact that successful democratization occurred through such a wide variety of different modes suggests that the mode of transition is not very relevant to explaining post-communist regime change.

However, the causal mechanisms identified by the transitologists *can* account for differences in the extent of criminal corporate raiding and the emergence of effective property rights institutions. As we have already seen, where the transition took the form of elite survival, this ensured the persistence of soft budget constraints. However, transitions that occurred by means of negotiated pact, as in Poland, led to the same outcome. In particular, revolutionaries who came to power through such pacts were obliged to provide a “soft landing” for the communists with whom they had just negotiated. The soft landing had two components. First, during the late communist period the nomenklatura had often appropriated substantial amounts of state assets for themselves through illicit soft budget constraints (typically input-output schemes). The Polish Solidarity government would have to recognize the legality of these siphoned assets. Second, the option of immediately implementing comprehensive hard budget constraints across the economy was off the table; the communist establishment wanted to make sure they were well-positioned to enrich themselves through continued soft budget constraints. This, some observers have credibly suggested, was a necessary part of the deal to which Solidarity had to agree (Figure 3.12).⁴⁶

If a government of revolutionaries was to have any chance to fully impose hard budget constraints, they had to have come to power through the whole-scale replacement of the old regime. Replacements of this sort occurred in Czechoslovakia and the Baltic states. They created a brief yet critical interlude in which to harden budget constraints. Nevertheless, the first governments in Czechoslovakia and its successor states would fail to seize this opportunity. The result would be the widespread theft of state assets. The Pro Patria government in Estonia did carry out these measures and thereby avoided the large-scale transfer of state assets into the hands of political thugs and crony capitalists. Thus, the avoidance of raiding and the formation of effective property rights institutions required that revolutionaries come to power through replacement *and* take immediate and drastic action to turn off the taps of politically-allocated soft budgets.

Even though the mode of transition could have taken any of three possible forms – elite-led imposition, negotiated pact, or replacement – what mattered for the purpose of this analysis was whether or not the transition occurred through replacement. If it took either of the other two forms, early post-communist governments would find themselves severely constrained in attempts to harden budget constraints. The operative variable, then, is not trichotomous but dichotomous: did the transition take place by replacement, or not?

To summarize, whether or not revolutionaries came to power and the mode by which they ascended determined the leeway post-communist governments had to institute hard budget constraints. But this leeway was not enough; having risen to power through replacement, a new revolutionary government had actually to take advantage of the

⁴⁶ Maria Łoś and Andrzej Zybertowicz, *Privatizing the Police-State: The Case of Poland* (New York: Palgrave Macmillan, 2000), 109-36; Carmen González Enríquez, "Elites and Decommunization in Eastern Europe," in *Postcommunist Elites and Democracy in Eastern Europe*, ed. John Higley, Jan Pakulski, and Włodzimierz Wesolowski (New York: St. Martin's, 1998), 280-82.

opportunity. For such governments, the implementation of hard budget constraints was a matter of choice and an enormously consequential one at that.

Elite Ascendance: Measuring the Causal Variables

Having outlined the relationships among the causal variables at the elite-ascendance stage, we must now turn to the question of how they will be operationalized. Scholars have used a variety of methods to measure the strength of party competition. Among these are the degree of parliamentary fragmentation, the effective number of political parties, the entrance of new parties from election to election (party system openness), ideological polarization, the amount of volatility in a given party's electoral support, and the percentage of votes wasted on parties that fail to pass the minimum electoral threshold.⁴⁷ In order to explain variations in the degree of fraud in the largest privatizations, these indicators should display a clear difference between Estonia and Poland, on the one hand, and Slovakia, on the other. However, they all fail to do so (Table 3.7).⁴⁸

There are three indicators which do vary in the right manner to account for the different outcomes. Each measures a separate dimension relating to the strength of party competition. The first dimension is the extent to which parliamentary parties are *critical* of the government, as measured by the average annual number of formal questions that MPs put forward to it.⁴⁹ Such questions involve extensive preparation and force the government to account for its actions. "In short, parliamentary questions [are] both an indicator of the vigor of the opposition and its readiness to assume national power."⁵⁰ In this regard, there is a clear difference between Poland and Estonia, on the one hand, and Ukraine and Slovakia, on the other (Table 3.8). Unfortunately, Ukraine did not begin collecting data on the number of parliamentary questions asked until 1998. As a result, the Ukrainian data covers a different time period (1998-2013) than the data for the other countries (which extends from the start of the post-communist period until 2004). Nevertheless, it was precisely during these years when the ten biggest privatizations in Ukraine took place.

The second dimension is the degree to which all parties are regarded as *plausible* candidates for inclusion in ruling coalitions. "Where there are few plausible competitors, governing parties rest easier, knowing that neither elections nor defections can easily produce an alternative governing coalition," Grzymała-Busse points out. Plausibility is measured by the "share of parliamentary seats held by parties that have not been excluded *by all other parties* as potential coalition partners."⁵¹ However, with the exception of a few years following the Orange Revolution of late 2004, Ukraine's presidential system did not necessitate an actual coalition of parties to run the government. Considering this, the plausible parties measure is not relevant for that country. But it does apply to

⁴⁷ Grzymała-Busse, 49-58.

⁴⁸ I have not included the relevant data for Ukraine since a comparison between the other three countries is sufficient on its own to falsify the utility of these various causal mechanisms.

⁴⁹ See Grzymała-Busse, 14.

⁵⁰ Ibid., 12-13.

⁵¹ See *ibid.*, 11-12..

Table 3.7. Party Competition Indicators that Fail to Explain the Variant Outcomes

	<u>Fragmentation</u>	<u># of Effective Parties</u>	<u>Openness</u>	<u>Polarization</u>	<u>Electoral Volatility</u>	<u>Excluded Vote (avg.)</u>
Estonia	0.79	4.8	7.2	12.0	39.5	10.1
Poland	0.77	4.9	15.8	31.8	29.0	14.0
Slovakia	0.78	5.2	17.1	4.9	31.5	14.6

Source: Grzymala-Busse (2007), 54

Table 3.8. Party Competition Indicators that Successfully Explain the Variant Outcomes

<u>Questions per MP*</u>		<u>Questions per MP in Ukraine (by Year)</u>		<u>Longest Tenure of Ruling Party in Office During Main Era of Privatization</u>		
<u>Country</u>	<u>Questions per MP (by Country)</u>	<u>Year</u>	<u>Questions per MP</u>	<u>Country</u>	<u>Longest Tenure (months)</u>	<u>Dates</u>
Estonia	3.54	1998	0.40	Estonia	48	Mar. 1995 to Mar. 1999
Poland	3.78	1999	0.93	Poland	48	Oct. 1997 to Oct. 2001
Slovakia	0.94	2000	0.65	Slovakia	92	Nov. 1998 to July 2006
Ukraine	1.22	2001	0.73			
		2002	0.54			
		2003	2.08			
		2004	2.51			
		2005	4.13			
		2006	0.94			
		2007	0.08			
		2008	0.38			
		2009	0.92			
		2010	0.67			
		2011	1.43			
		2012	1.18			
		2013	1.93			
		<u>Average</u>	1.22			

<u>Average Seat Share of Plausible Parties</u>	
<u>Country</u>	<u>Avg. Seat Share (%)</u>
Estonia	1.00
Poland	0.97
Slovakia	0.81

*Average annual number of questions asked per MP

Sources: Grzymala-Busse (2007), 14; Grzymala-Busse (2003); Verkhovna Rada Department of Control (Ukraine)

Estonia, Poland, and Slovakia and will accordingly be used to differentiate the varying levels of party competition in those three places (Table 3.8)

The third dimension is the extent to which the opposition can credibly threaten to oust ruling parties in elections. To assess the opposition's *credibility*, I will use Grzymala-Busse's measure of incumbency, or the number of months since the onset of political liberalization in which the longest-serving incumbent government continuously held power (Table 3.8). One problem with this measure is that the longest-serving governments in Poland and Estonia are ones that are currently in power as of this writing. But considering these governments in the measure would not shed light on the most important factor for our purposes, which is the length of time served by the longest government *during the era in which most of the privatization process occurred*. While privatization continues in Poland today, much of the process has already finished. Furthermore, what is relevant for this study is how the *current* business elite made its

fortune and the effects this had on the frequency of raiding. The privatizations occurring now will surely influence the extent of raiding in the future, but we are concerned here with explaining past developments, not future ones. As for Estonia, virtually all privatizations took place in the 1990s. Obviously, the strength of party competition today, as indicated by the tenure of the current government, cannot account for events during the first post-communist decade. Thus, the data in Table 3.8 reflects incumbency during the 1990s only.

Like the share of seats held by plausible parties, this indicator too is not applicable to Ukraine, again because of its presidential system; for most of the post-communist period, Ukrainian presidents have been able to appoint and dismiss governments virtually at will and have made liberal use of this prerogative. In addition, much of the turnover that occurred was not the result of a vigorous parliamentary opposition forcing the president's hand. It rather reflected efforts by the president to balance off rival patron-client networks vying for his influence – a phenomenon that is not at all related to the strength of the parliamentary opposition. Nevertheless, this indicator is relevant to the other three countries and will be considered in those cases. (Table 3.8).

Aside from the measures above, Grzymała-Busse also finds a strong correlation between elite rent-seeking and an additional indicator of party system robustness. This is whether the communist party regenerated itself and won the second post-communist election.⁵² However, being that she (and I) also cite this as a cause of party system robustness,⁵³ it would be inappropriate to use it as an indicator as well.

Two indicators were used to measure whether or not revolutionaries ascended. The first is the percentage of the vote received by non-communists in the first free elections. Nevertheless, we have already seen that the mere ouster of the communists says nothing about whether their successors were revolutionary or ethno-nationalist. Therefore, I combine the first indicator with a second that measures the share of GDP accounted for by the private sector as of 1995. This provides the key litmus test to determine just how revolutionary the first post-communist government was. To be sure, by 1995 many of the revolutionary governments that came to power immediately after the fall of communism had been ousted. However, where such governments did take power initially, their revolutionary policies established a decisive break with communist-era arrangements. Subsequent governments, without exception, found themselves unable or unwilling to fully reverse the market transformation. Once the revolutionary agenda had been firmly set in place, no party that favored a return to the communist-era status quo could possibly hope to emerge victorious in subsequent elections. Even where committed leftist parties replaced the original revolutionary governments, they displayed a firm commitment to preserving the basic essence of the new market system.⁵⁴

Thus, only those countries where *both* a majority of the first post-communist parliament consisted of non-communists *and* private sector output accounted for more than half of GDP by 1995 will be deemed as having undergone a takeover by revolutionaries. Where either of these conditions were absent, it suggests that ex-communists and/or ethno-nationalists, not revolutionaries, emerged predominant (Table

⁵² Ibid., 11.

⁵³ Ibid., 61-63.

⁵⁴ Fish, "The Determinants of Economic Reform in the Post-Communist World."

**Table 3.9. Ideological Profile of First Post-Communist Government
(by Country)**

	<u>% Noncommunist seats in 1st election</u>	<u>Private sector share of GDP (1995)</u>	<u>Government Profile</u>
Czech Republic	84.0	70	Revolutionary
Poland	87.0	58	Revolutionary
Slovakia	85.0	59	Revolutionary
Hungary	83.2	60	Revolutionary
Estonia	74.3	61	Revolutionary
Latvia	73.0	58	Revolutionary
Lith	67.3	56	Revolutionary
Slovenia	87.0	38	Reformist
Armenia	89.8	45	Ethno-nationalist
Croatia	75.0	48	Ethno-nationalist
Georgia	74.0	30	Ethno-nationalist
Moldova	54.4	30	Ethno-nationalist
Azerbaijan	22.2	25	Ethno-nationalist*
Albania	32.0	60	Ex-communist
Bulgaria	48.0	36	Ex-communist
Russia	14.0	59	Ex-communist
Romania	33.0	38	Ex-communist
Kyrgyzstan	0.0	40	Ex-communist
Uzbekistan	5.0	30	Ex-communist
Belarus	21.0	12	Ex-communist
Kazakhstan	5.6	25	Ex-communist
Tajikistan	5.0	15	Ex-communist
Turkmenistan	5.0	15	Ex-communist
Ukraine	17.1	37	Ex-communist
Macedonia	74.7	40	(Mixed case)**

Sources: Darden & Busse (2006), Fish (1997)

*In Azerbaijan, the communists did not formally lose power during the transition. However, if they maintained control over the formal reins of government they most certainly lost control of the political agenda, which by and large came to be shaped by radical ethno-nationalist movements, most notably the Azerbaijani Popular Front. See Stuart J. Kaufman, *Modern Hatreds: The Symbolic Politics of Ethnic War* (Ithaca, NY: Cornell, 2001), 167-74.

**Mixed case (see Chapter Three text)

3.9). Only revolutionaries could potentially be both committed to large-scale privatization and free of burdensome ties to the old communist establishment. Ethno-nationalists tended to be far more concerned with beating up on rival ethnic groups than carrying out a sweeping market revolution.

As for the ex-communists, their primary aim was not to spearhead a market transformation but rather enrich themselves through partial economic reform.

Privatization was hardly necessary to achieve this goal given the control they already wielded over state assets. Moreover, new private sector entrants could only provide unwelcome competition. In some cases (particularly Russia) governments under the control of ex-communists did oversee privatization on a substantial scale. But even there, the new leaders remained entangled in webs of patron-client ties that bound them to the old nomenklatura. This rendered them unable (or unwilling) to completely cut off economic actors from soft budget constraints, the only measure that might enable effective property rights institutions to emerge.

As Table 3.9 shows, the only countries where revolutionaries took power were Czechoslovakia and its successor states along with Poland, Hungary, Estonia, Latvia, and Lithuania. Slovenia, as discussed above, saw the rise not of revolutionaries but reformists committed to a gradual shift toward the market. Elsewhere, newly-ascendant governments were either ethno-nationalist or ex-communist.

Like revolutionaries, ethno-nationalists too can be defined by the actions they took. In particular, ethno-nationalist leaderships were those that went to war on behalf of some national group they claimed to represent. Countries where such leaderships ascended included Armenia, Serbia, Bosnia-Herzegovina, Croatia, Georgia, Moldova, and Azerbaijan. Note from Table 3.9 that none of these countries fulfilled both conditions that are necessary to characterize an initial post-communist government as revolutionary; while most saw first elections that were won by non-communists, none had private sectors accounting for at least 50% of GDP by 1995. (Private sector data for Serbia and Bosnia are unavailable.) Meanwhile, the “ex-communist” designation in Table 3.9 is given to initial post-communist leaderships that fulfilled none of the conditions necessary to mark them as either revolutionary or ethno-nationalist.

The one case where the profile of the first post-communist government was not so clear-cut was Macedonia. While non-communists, led by the ethno-nationalist VMRO-DPMNE, did gain a majority of seats in the first free elections (in 1990), the resulting government, in power from March 1991 to July 1992, was supported by all major parties and composed mostly of non-affiliated “experts.” In September 1992, the ex-communist Social Democrats formed a new government and would hold onto power for the next six years. Therefore, Macedonia is a mixed case and cannot be characterized according to whether revolutionaries, ex-communists, or ethno-nationalists assumed control.⁵⁵

If assessing the character of the new government is straightforward, so is identifying the mode of transition. *Replacement* occurred where the rise to power of the opposition was *not* preceded by formal negotiations with the regime. This occurred in Czechoslovakia, Slovenia, Lithuania, Latvia, Estonia, Croatia, Bosnia, Georgia, Armenia, and Macedonia. In Poland and Hungary, new governments came to power following formal *negotiated pacts* between regime and opposition. Everywhere else, the transition occurred by elite imposition, initiated and managed by the former communist elite.

⁵⁵Janusz Bugajski, *Ethnic Politics in Eastern Europe: A Guide to Nationality Policies, Organizations, and Parties* (New York: M.E. Sharpe, 1994), 124-25; Stefan Krause, “Defying the Odds by Remaining Stable,” in *Holding the Course*, ed. EastWest Institute (New York: M.E. Sharpe, 2000), 236; International Crisis Group, *New Faces in Skopje, Lessons from the Macedonian Elections and the Challenges Facing the New Government* (Brussels: International Crisis Group, 1999). “Past Election Results in Macedonia,” *BalkanInsight*, 28 April 2011 (<http://www.balkaninsight.com/en/article/past-election-results-in-macedonia>);

Romania is a mixed case. Despite the violent revolution that overthrew longtime ruler Nicolae Ceaușescu, the communists still managed to hold onto power. Thus, the mode of transition there cannot be characterized as replacement. But neither was it entirely managed by the ruling communist elite.

Why Some Actors Choose to Raid While Others Do Not

Now that we have accounted for cross-national differences in raiding and the emergence of property rights institutions, we must now explain variations across business actors in the degree to which they engage in raiding. Those businesspeople who focus on innovating new products, technologies, and services succeed because they possess the experience and resources necessary to do so. Alternatively, those who engage in criminal corporate raiding choose this particular approach because that is where their own distinct comparative advantage lies. The two strategies involve entirely separate imperatives. The first requires creativity, the capacity for efficient production in a competitive marketplace, and access to arms-length (as opposed to cronyist) financing. The second necessitates an enormous investment in the political connections necessary to undertake raids. Politicians, government ministers, judges, police captains, and bureaucratic officials at all levels must be bought off or otherwise suborned into collusion with the would-be raider.⁵⁶ An entrepreneur lacks the skills and resources to engage in raids just as a raider lacks the skills and resources to make innovative products at competitive prices. As subsequent chapters will demonstrate, the distinct background and strengths a given business actor possesses are what account for whether she will engage in raiding.

That much is readily apparent. But one might wonder why crony capitalists seem to refrain from criminal corporate raiding even though they evidently possess the political connections necessary to pull it off. The answer is that raiding is costly. To begin with, known raiders are unlikely to find congenial allies when at some point they must inevitably go looking for financing from banks or strategic partners. Few people are brave enough to get involved in a financial relationship with someone who has a reputation for intimidation and forced expropriation.⁵⁷

Still, can such a reputation not prove an asset as well as a liability? One might be tempted to think that it can. After a while, all it took for Ukraine's Rinat Akhmetov or Bulgaria's Ilya Pavlov to take over a business was a simple meeting with the takeover target in which it was "suggested" that the owner sell out. However, the more one relies on illegal force to separate owners from their property, the more enemies one accumulates. In addition to the people the raider has already alienated are those who fear becoming victims in the future. Describing the current dilemma facing one particular raider, a Russian businessman eloquently sums up the problem:

Take Z, for him it is a problem he must be thinking right now. Okay, he is in Putin's shadow now, for cover-up and for protection, but once he is in the street, or Putin forgets about him, he has a lot to answer for... It is one thing when a matter is political and quite another when you send someone to prison and take over his business. This is serious and people will not

⁵⁶ Volkov, "Hostile Enterprise Takeovers: Russia's Economy in 1998–2002."

⁵⁷ Volkov, 97-125.

just forget it or forgive it. It is not that simple...and one has to have bodyguards...vengeance catches up with you in different ways.⁵⁸

Anybody who chooses raiding as a primary or even occasional business practice is entering a world of danger. Crony capitalists realize this and are able to succeed in business without taking such perilous risks anyway. That being the case, there is not much incentive for the crony capitalist to treat raiding as a viable tactic.

We now have a preview of why some business actors engage in criminal corporate raiding while others do not. It depends on a given actor's experience, skills, and resources. Entrepreneurs and crony capitalists by and large possess the requisite resources to make money by means other than siphoning and raiding. Political thugs do not; their initial success in business along with their particular comparative advantage compel them to rely on the use of force to acquire assets – even if this means amassing a multitude of enemies in the process. Lacking any other particular talents, they find themselves hemmed in to strategy of raiding, accessing soft budget constraints, or both – despite the potentially damaging costs involved.

Conclusion

This chapter has elaborated upon the causal framework presented in Chapter One with the aim of tailoring it to the particular conditions of the post-communist region. It applied this framework to the question of why some countries experienced more raiding and weaker property rights institutions than others. The same analytical structure can be used to explain variations across business actors in the degree to which they relied on raiding. In each case, the ability of new post-communist governments to marginalize the power of predatory economic actors proved paramount. This could be accomplished only by forcing them to abide by hard budget constraints. Where governments failed to do take these measures, the result was to empower political thugs crony capitalists. This, in turn, made frequent criminal corporate raiding and weak property rights institutions an inevitability. The chapters that follow will demonstrate in great and gruesome detail how these causal processes unfolded in Ukraine, Poland, Slovakia, and Estonia.

The analytical framework presented here suggests the importance of understanding how actors shape institutions rather than limiting our inquiries into the ways institutions shape actors. We have seen three ways in which post-communist actors influenced the nature of institutions. First, actors in the form of revolutionary governments (where they indeed arose) had to decide how far to pursue hard budget constraints. As will become evident in later chapters, their choices in this regard were in part shaped by the means by which they came to power. Beyond that, agency would prove critical. Second, actors within that segment of the political elite that had been ejected from government – typically but not always the former ruling communist party – had to choose whether to build strong opposition parties able to check the power of the new leadership. Only this could prevent large-scale fraud in the biggest privatizations. Third, the degree to which a wealthy, powerful class of political thugs and crony capitalists emerged – itself a result of how far revolutionaries went in hardening budget

⁵⁸ Quoted in Alena V. Ledeneva, *Can Russia Modernize?: Sistema, Power Networks and Informal Governance* (Cambridge and New York: Cambridge, 2013), 38.

constraints – determined the prospects that capable property rights institutions could develop.

“There were a number of people back then in the Donbass who wanted to be like [Rinat] Akhmetov, who wanted to grow as fast as he did, and who had his ambition. But they are no longer alive. Therefore, Akhmetov simply had no competition in as much as he commanded very serious resources... The reason they weren’t able to succeed is the same reason why Akhmetov is now a billionaire, why he is the richest man in Ukraine.”

—Respondent #63¹

“If Ukraine wasn’t so badly mismanaged and corrupt, the country would be doing just fine.”

—U.S. Senator John McCain²

Chapter Four

Fear and Loathing in Post-Communist Ukraine

For a brief time during late 2004, the eyes of the world became fixated on the dramatic developments enveloping one of Europe’s largest and most geopolitically significant countries. After their leaders attempted to falsify the results of presidential elections in favor of Viktor Yanukovich, the incumbent Prime Minister, masses of Ukrainian citizens swarmed upon streets of Kyiv to make sure they would not get away with it. For days on end, hundreds of thousands of peaceful protesters created a festival-like atmosphere in the capital centered around Independence Square despite the sub-freezing temperatures. They ultimately succeeded in forcing a rerun of the elections with the result that Yanukovich’s rival, the opposition-backed Viktor Yushchenko – his face permanently scarred from a previous ricin poisoning – emerged as the new President. The Orange Revolution, as it came to be called, spurred euphoric hopes among many, both within and beyond Ukraine, that a better future was upon them.

Exactly nine years later, protestors once again descended onto the streets of the capital. Initially, they were protesting the abrupt refusal of Yanukovich, now the President, to move forward on an association agreement with the European Union. Within weeks, however, their demands escalated to encompass nothing less than the President’s resignation. For the first time in the history of post-communist Ukraine, mass protests turned violent as demonstrators erected barricades of fire, attacked police and security officials, and destroyed government property. Mainstream opposition leaders quickly lost any authority they may have briefly had over the crowds as an increasingly radical set of political organizations began to displace them. The so-called Euromaidan

¹ Interview with the author.

² “Washington hawks urge tougher stance on Ukraine,” *Financial Times*, 25 February 2014.

revolt ultimately forced the resignation and flight of President Yanukovich and his coterie of corrupt rascals. When all was said and done, hundreds of people were killed or injured before the police, army, and key allies defected from the President while parliament, ignoring constitutional procedure, voted him out of power.

If the Orange Revolution of 2004 brought about the peaceful end to a corrupt regime, why did the Euromaidan demonstrations of 2014 descend into such violence? The reasons are many and must certainly include the authorities' ham-fisted and violent response to the initially peaceful protests and their short-lived attempt to turn the country into a legal dictatorship. But a critical underlying subtext was popular bitterness and anger towards a blatantly corrupt and self-serving elite. The dominance of this elite and their massive and continuous theft of assets from both the state and private citizens is what makes the above statement from Senator McCain just a tad tautological. Indeed, the corruption and criminality of the pre-Orange era did not at all abate after the people of Ukraine swept their opposition leaders into power in 2004. In light of this, they might have been forgiven for doubting the credibility a new set of opposition leaders in 2014. Their reluctance to be fooled twice may go far in explaining why mainstream opposition representatives such as Vitaly Klitchko and Arseny Yatsenyuk failed to hold sway over the crowds and the uprising instead spiraled out of control.

This chapter will detail the emergence of this criminal economic system in early-capitalist Ukraine. It will demonstrate that criminal corporate raiding and weak property rights institutions have become a basic fact of political life. It will also show how the causal framework outlined in Chapter Three can account for this outcome. The failure of a revolutionary opposition to take power and displace the old ruling elite during the early post-communist years set the stage for much of what followed. Instead, an incipient class of predominantly ex-communist political thugs circulating within and around state enterprises found ready patrons in the corrupt former nomenklatura who continued to dominate the state. This left them well-positioned to secure the continued provision of soft budget constraints. Many of these political thugs became rich in the 1990s from the flow of gas into the country from Russia and Central Asia. Others used their control of state-owned firms to continually strip them of assets while the state maintained a steady stream of soft credits and subsidies to replenish the hollowed-out enterprises. In this way, the absence of revolutionaries at the helm of government along with the elite-led mode of transition enabled new business actors grow rich from soft budget constraints.

Fraudulent sales of state enterprises at a fraction of their value served as another source of soft budget constraints. The corrupt nature of the privatization process resulted from weak party competition; the lack of a vigorous opposition that could credibly check the power of successive governments gave Ukraine's leaders carte blanche to engineer the blatantly fraudulent privatization of the largest state enterprises; as we will see, at least eight of the ten biggest privatizations in post-communist Ukraine were marked by serious corruption.

Taken together, the abundant opportunities to siphon state assets through soft budget constraints ensured that political thugs would come to occupy a prominent place among both the plutocratic and non-plutocratic elites. This fact, more than any other, explains the pervasiveness of criminal corporate raiding in the business world of early-capitalist Ukraine. Of the 40 individuals who have appeared on published lists of the top-20 richest people from 2007 to 2012, between 53 and 65 percent can be considered

Table 4.1. Ukraine's Plutocratic Elite

Name	Alleged Type	Raiding?
Leonid Baysarov	CC	
Vyacheslav Boguslayev	CC	
Leonid Chernovetsky	CC	
Valery Khoroshkovsky	CC	
Viktor Nusenkis	CC	
Fyodor Shpig	CC	
Yevhen Sigal	CC	
Heorhiy Skudar	CC	
Serhiy Taruta	CC	X
Oleksiy Vadatursky	CC	
Andriy Verevsky	CC	
Yury Kosyuk	CC	
Vitaliy Antonov	E or CC	
Oleh Mkrtchan	E	
Rinat Akhmetov	PT	X
Hennady Bogolyubov	PT	X
Volodymyr Boyko	PT	
Dimytro Firtash	PT	?
Vasily Gorbal'	PT	
Konstantyn Hryhoryshyn	PT	X
Vitaly Hayduk	PT	?
Yury Ivanyushchenko	PT	X
Vasily Khmel'nitsky	PT	
Borys Kolesnikov	PT	X
Ihor Kolomoysky	PT	X
Oleksiy Martynov	PT	X
Volodymyr Matviyenko	PT	
Vadim Novinsky	PT	X
Eduard Shifrin	PT	
Oleksandr Shnaider	PT	
Serhiy Tihipko	PT	X
Oleksandr Yaroslavsky	PT	?
Kostyantyn Zhevago	PT	X
Evhen Chernyak	PT	
Viktor Pinchuk	PT	
Petro Poroshenko	CC or PT	X
Ivan Huta	CC or PT	
Oleh Bakhmatyuk	CC or PT	X
Tariel Vasadze	CC or PT	?
Leonid Yurushev	CC or PT	X

Raiders	% of Pluto Elite
Raiders	35.0%
Possible Raiders	45.0%
Actor-Types	
E	2.5%
E or CC	2.5%
CC	30.0%
CC or PT	12.5%
PT	52.5%
Entrepreneurs	2.5% to 5%
Crony Capitalists	30% to 45%
Political Thugs	52.5% to 65%
CC & PT Combined	82.5% to 97.5%

Key*CC = Crony Capitalist**E = Entrepreneur**PT = Political Thug*

political thugs. Only one person on the list is a definite entrepreneur while one other is a possible entrepreneur; the rest are either political thugs or crony capitalists (Table 4.1).

The prevalence of political thugs made frequent raiding inevitable. Thirty-five to 45 percent of the plutocrats have engaged in at least one raid (in a few cases, the participation of particular individuals in a given raid could not be substantiated). All but two of those who engaged in raids are either definite political thugs or probable political thugs (the other two, if not political thugs, are certainly crony capitalists) (Table 4.1). Raiding has proven equally common among the non-plutocratic elite, with at least one raid occurring in seven of nine economic sectors (Table 4.2).

If an abundance of political thugs led to widespread raiding, the combined presence of political thugs and crony capitalists ensured that property rights institutions would remain weak. The experience of Ukraine demonstrates how dense networks of economic criminals and their bidders in the political establishment, the courts, police, and regulatory agencies engage in conspiracies to enfeeble market-supporting institutions and expropriate the property of others.

We will also see pernicious feedback effects at work. Soft budget constraints begat wealthy political thugs, which begat further soft budget constraints. The acquisition of additional wealth through criminal corporate raiding further boosted the influence of political thugs, allowing them to extract even more state largesse from their cronies in the state administration.

The chapter will begin by showing how the failure of revolutionaries to take power along with the elite-led nature of the transition led to the continuation of soft budget constraints. It will also demonstrate how weak party competition set the stage for the corrupt privatization of the state's crown jewels. Next, we will turn to a series of case studies that illustrate how Ukraine's political thugs emerged on the back of soft budget constraints and subsequently turned their attention to raiding. The case studies will start with the non-plutocratic elite and then move on to the plutocratic stratum. If the dozens of criminal corporate raids were not enough, the final section provides further evidence of the general weakness of Ukraine's property rights institutions.

Explaining the Rise of Ukraine's Political Thugs

While the other three countries, at least for a time, saw the ascendance of revolutionary oppositions to power during the transition from communist rule, Ukraine certainly did not. There, the former communist elite held onto power well into the post-communist period. Indeed, they continue to dominate much of the political establishment even today. The mode of transition in Ukraine was thus a classic case of elite survival. This stands in contrast to the other three countries, where transitions took the form of negotiations between regime and opposition or the wholesale replacement of regime by opposition.

Despite the opening of the political system in the late 1980s and the subsequent downfall of the Soviet regime, in Ukraine there was no break in the nomenklatura's hold on power.³ A budding revolutionary-nationalist political movement in the form of *Rukh*

³ Over 80 percent of those elected to the parliament in the 1990 Supreme Soviet elections were Communist Party members. This figure is taken from Taras Kuzio, *Ukraine: Perestroika to Independence* (New York: St. Martin's, 2000), 170. Most Communist Party officials elected to the 1990 Supreme Soviet subsequently

did emerge during the transition. While Rukh alternately supported certain governments into the mid-1990s, it never managed to assume full control for itself like its counterparts elsewhere did. Instead, from the late 1980s, many of the ruling communists co-opted key portions of the nationalist agenda, metamorphosing into so-called “national communists” in the process. Indeed, over 80 percent of the deputies elected to parliament in the 1990 elections were Communist Party members.⁴ At least 60 percent of the deputies who entered parliament after the 1994 elections consisted of members of the communist-era nomenklatura.⁵ In addition, the country’s first two presidents, Leonid Kravchuk (1991-94) and Leonid Kuchma (1994-2004), had previously been prominent communist party figures. So were a majority of those who served in their governments and presidential administrations.

However, in the early- and mid-1990s the national communists were too politically weak to rule entirely on their own and so enlisted the support of Rukh. But the tenuousness of the opposition’s influence would become apparent from 1998 onward once the former communist leadership had become sufficiently strong to rule by itself.⁶ Labeled the “party of power” by political commentator Mykola Ryabchuk, it was made up of “pragmatically oriented and de-ideologized high ranking members from the old nomenklatura, including representatives of the state *apparat*, the mass media, and directors of the traditional sectors of industry and agriculture.”⁷

The failure of a revolutionary opposition to take power would hamper any efforts, however, modest, to impose hard budget constraints on firms. As the economic catastrophe that began under Gorbachev continued to worsen into Kravchuk’s presidency, there was little appetite among enterprise managers for new experiments in market-based economics. Rather, they staunchly demanded the continuation of state subsidies and soft financing. Given the dense links between members of his administration and these ex-communist managers, Kravchuk was in no position to ignore them. Those genuine market reformers who did hold positions in the government

formed the “Group of 239” (out of 450 total seats in the Supreme Soviet) shortly following the elections. At least 60 percent of the deputies in the 1994 parliament consisted of members of the communist-era nomenklatura. This figure is compiled by adding the total share of the parliamentary seats held by the following factions, all of which are known to consist nearly entirely of members of the communist-era nomenklatura: the Communist, Agrarian, Socialist, Center, Union of Industrialists and Entrepreneurs, Independents, Agrarians for Reform, and Unity. All together these factions made up 273 of 450 seats. For figures on the share of the seats held by these different factions, see Taras Kuzio, *Ukraine under Kuchma: Political Reform, Economic Transformation and Security Policy in Independent Ukraine* (New York: St. Martin’s, 1997), 37. In addition, both Ukraine’s first President, Leonid Kravchuk, along with Leonid Kuchma, the second President, were former apparatchiks. So were a majority of the ministers in both of their governments.

⁴ This figure is taken from Kuzio, *Ukraine: Perestroika to Independence*, 170.

⁵ This figure is compiled by adding the total share of the parliamentary seats held by the following factions, all of which are known to consist nearly entirely of members of the communist-era nomenklatura: the Communist, Agrarian, Socialist, Center, Union of Industrialists and Entrepreneurs, Independents, Agrarians for Reform, and Unity. All together these factions made up 273 of 450 seats. For figures on the share of the seats held by these different factions, see Kuzio, *Ukraine under Kuchma: Political Reform, Economic Transformation and Security Policy in Independent Ukraine*, 37.

⁶ Taras Kuzio, “The downfall and discrediting of Ukraine’s first President Kravchuk,” *The Ukrainian Weekly*, January 2, 2005. Available at <http://www.ukrweekly.com/old/archive/2005/010504.shtml>.

⁷ Quoted in Paul Kubicek, *Unbroken Ties: The State, Interest Associations, and Corporatism in Post-Soviet Ukraine* (Ann Arbor, MI: University of Michigan, 2000), 42.

Table 4.2. Alleged Non-Plutocratic Raids

<u>Raid #</u>	<u>Target</u>	<u>Sector</u>	<u>Alleged Perpetrator</u>	<u>Pol. Thug?</u>
1	Resp. #59 (1995)	1	"Russian oil mafia"	?
2	Resp. #59 (1997)	1	(unknown)	?
3	Industrial Union of Donbass	4	UESU	Yes
4	KIT Limited	?	V. Shcherban	Yes
5	Gala Radio	5	(unknown)	?
6	Slavyansky Bank	6	Kuchma	Yes
7	Volodymyr Shandra	3	Kuchma	Yes
8	Serhiy Danylov	5	Kuchma	Yes
9	Yevhen Chervonenko	4	Kuchma	Yes
10	Golden Telecom	5	(unknown)	?
11	Mykolayiv Aluminum Plant	2	TWG Consortium	Yes
12	Starwood Zakarpattia	2	Other shareholders	?
13	Farmers	1	(unknown)	?
14	Maurits Stamm	1	Petro Yevych	?
15	(American agro business)	1	(unknown)	?
16	Polisyntez	2	(unknown)	?
17	Dolmart	4	Kalchenko	?
18	Kvazar	2	Two political thugs	Yes
19	Energo	2	Gennadiy Vasiliev	Yes
20	Vanco	2	Tymoshenko	Yes
21	Kyivhorstroy	3	Yanukovich's "Family"	Yes
22	Metalist	9	Yanukovich's "Family"	Yes
23	Valery Khoroshkovskiy	5	Yanukovich's "Family"	Yes
24	Vsesvit	5	Businessmen linked to Party of Regions	?
25	Ilyich Iron & Steel Works	2	Businessmen linked to Vneshekonombank	Yes
26	Kryvorizhstal	2	(unknown)	?
Percent who are political thugs				53.8%

Sector Key

<u>Sector #</u>	<u>Sector Name</u>	<u>Raid?</u>	<u>Sector #</u>	<u>Sector Name</u>	<u>Raid?</u>
1	Agriculture, forestry and fishing (ISIS Rev. 4 Sec. A)	X	5	Information and communication (J)	X
2	Manufacturing, mining and quarrying and other industry (B, C, D, E)	X	6	Financial and insurance activities (K)	X
3	Construction (F)	X	7	Real estate activities (L)	
4	Wholesale and retail trade, transportation and storage, accommodation and food service activities (G, H, I)	X	8	Professional, scientific, technical, administration and support service activities (M, N)	
			9	Other services (R, S, T, U)	X

invariably found themselves hamstrung in their attempts to bring order to the economy; they were vastly outnumbered and outmaneuvered by the ex-communist heavyweights who dominated the political system. Kuchma himself, while serving as Prime Minister under Kravchuk, was forced to abandon his modest economic reform agenda in the face of staunch opposition from his own supporters, who consisted mainly of state enterprise directors and individuals from the military-industrial complex.⁸

Soft budget constraints thus persisted in the form of state subsidies, loans, credits, and tax breaks to state-owned firms as well as partial price controls (most importantly in the sale of gas by the state, as we will see). Table 4.3 shows the extent to which the hardening of budget constraints had completely failed to get off the ground in Ukraine by the second year of the transition.

This created abundant opportunities for well-connected actors to siphon off state wealth into their own hands, as illustrated by the scale of non-performing loans (Table 4.4); while a good chunk of these loans simply reflected an overhang of bad debts from the communist era, much of it consisted of new loans created after independence that ended up disappearing into the abyss (as the case studies will show). Although hard numbers are difficult to come by (at least before 1999), Ukraine clearly had a major problem with non-performing loans (NPLs) during the 1990s. According to Laeven & Valencia, NPLs peaked in 1998 at 62.4 percent of all loans outstanding, having reached “50-65% of assets even in some leading banks” between 1995 and 1997.⁹

The overhang of bad loans from the Soviet period surely accounted for a large portion of this problem. But new lending in the post-communist era was at least as responsible. Following the creation of a new currency, the *karbovanets*, in January 1992, the National Bank of Ukraine (NBU) began flooding the economy with money that was in turn channeled to economic enterprises by commercial banks. “Commercial banks lent aggressively through 1993 with little or poor security, and paid no attention to cash flow in a market sense,” according to Borish and Montes-Negret. But the NBU did not make these funds available to just anybody; political connections often decided who would receive them. “Banks that had a greater capacity to obtain funds or approval for transactions from the National Bank of Ukraine prospered. Contacts in the government played a significant role in this process.”¹⁰ The World Bank estimated that, as of 1997, the big three state banks – Bank Ukraina, Prominvestbank, and Ukrsotsbank – had lent between \$250 million and \$450 million in loans to state enterprises on direct orders from the government.¹¹ Moreover, many of the new commercial banks were established by firms for the express purpose of obtaining easy financing. Consequently, “their criteria for resource management were usually captive to the prerogatives of enterprise owners, and were often noncommercial.” Not surprisingly, many of these banks ran into serious financial trouble due to NPLs. By 1996, the government had begun to rein in some of these excesses with better banking supervision.¹² However, by that point the damage had

⁸ Ibid.

⁹ Laeven and Valencia, 48.

¹⁰ Michael Borish and Fernando Montes-Negret, “Restructuring Distressed Banks in Transition Economies: Lessons from Central Europe and Ukraine,” in *Preventing Bank Crises: Lessons from Recent Global Bank Failures*, ed. Jr. Gerard Caprio et al. (Washington: The World Bank, 1998), 105.

¹¹ Laurie Landy, *Developing Sound Banks in Transitional Economies: Structural Reforms in Ukraine* (Warsaw: Center for Social and Economic Research (CASE), 1997), 15-16.

¹² Borish and Montes-Negret, 103-10.

Table 4.3: The Degree and Speed with which Hard Budget Constraints were Instituted (1-2 years into transition)

	<u>Enterprise Restructuring</u>	<u>Price liberalization</u>	<u>Banking Reform</u>	<u>Average</u>	<u>% Difference from Estonia</u>
Estonia (1993)	3.00	4.33	3.00	3.44	
Poland (1991)	2.00	3.67	2.00	2.56	-26.6%
Slovakia (1991)	2.00	4.00	2.00	2.67	-23.3%
Ukraine (1993)	1.00	1.00	1.00	1.00	-73.4%

Source: EBRD Transition Indicators (<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

already been done; as we will see, scores of political thugs had taken root thanks to soft bank loans.

Aside from the more “traditional” forms of soft budget constraints noted above, the tunneling of state enterprises and their subsequent sales in fraudulent privatizations constituted a particularly important soft budget constraint for emerging business actors. The fact that the transition was managed by the old nomenklatura left the levers of political and economic power in the hands of the most depraved and self-entitled elements of the post-communist elite. Because of the failure of revolutionaries to replace the old ruling class, scores of ex-communists who went into business found ready patrons among their ex-nomenklatura colleagues in the government and state administration.

Having abandoned any pretense of real market reform, Kuchma, upon becoming President in 1994, worked to build up a strategic constituency of allies among businesspeople with close ties to the former regime. He did so by appointing them to manage Ukraine’s most valuable state-owned firms. These individuals, some of whom simultaneously occupied official government posts, set up private trading companies in energy, agriculture, mining, and metals. Based mostly in the regions of Kyiv, Donetsk, and Dnipropetrovsk, they represented a powerful ruling group with a direct stake in preserving Kuchma’s hold on power. Possessing control over the state-owned firms who served as their main customers and suppliers, the trading companies engaged in highly one-sided transactions with these enterprises. They sold inputs at artificially high prices and bought the resulting output at artificially low prices, emptying the state-owned firms of assets in the process. The state enterprises stayed afloat only through the continuous provision of state subsidies and credits courtesy of Kuchma and his government.¹³

¹³ For information on this system, see: *Financial Times*, 21 August 1999, 10 November 1999 (“Survey: Central and Eastern Europe), and 12 November 1999; *RFE/RL Crime and Corruption Watch*, 6 December 2001, 13 December 2001, 20 December 2001, 27 December 2001, 21 March 2002, and 19 April 2002; *RFE/RL Poland, Belarus, and Ukraine Report*, 30 June 2000. For information on the mining industry, in particular, see Oleg Varfolomeyev, “Ukraine: Stuck in the Pits,” *Transitions Online*, 5 December 2002. Also see Kubicek, 81-83.

Table 4.4. Non-Performing Loans as % of All Loans, 1991-2000

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Avg.
Estonia			7.0	3.5	2.4	2.0	2.1	4.0	2.9	1.3	3.2
Slovenia				13.8	9.3	10.1	10.0	9.5	9.3	9.3	10.2
Latvia				11.0	19.0	20.0	10.0	6.8	6.8	5.0	11.2
Hungary	11.0	21.0	29.6	20.2	12.1	9.0	6.6	7.9	4.4	3.1	12.5
Belarus				8.4	11.8	14.1	12.5	16.5	13.1	15.2	13.1
Croatia				12.2	12.9	11.2	8.2	12.6	20.6	19.8	13.9
Serbia & Montenegro				10.3	12.0	12.3	15.1	13.1	10.2	27.8	14.4
Bulgaria	40.0		6.7	6.8	12.5	15.2	13.0	11.8	17.5	10.9	14.9
Lithuania				27.0	17.3	32.2	28.3	12.5	11.9	10.8	20.0
Poland	17.0	27.0	36.4	34.0	23.9	14.7	11.5	11.8	14.9	16.8	20.8
Czech Republic	3.0	19.0	22.0	34.0	26.6	21.8	19.9	22.7	43.4	39.7	25.2
Romania	6.0	5.0	4.0	18.5	37.9	48.0	56.5	58.5	35.4	3.8	27.4
Slovakia	3.0	19.0	12.2	30.3	41.3	31.8	33.4	44.3	32.9	26.2	27.4
Moldova				31.0	36.0	45.5	26.0	32.0	29.3	20.6	31.5
Ukraine								34.6	34.2	32.5	33.8
Bosnia and Herzegovina									58.7	13.9	36.3
Albania					34.9	40.1	91.3	35.4	32.7	42.6	46.2
FYR Macedonia						66.1	59.5	50.3	62.6	46.5	57.0

*NPL levels reflect latest available data. In some cases (see references to Hungary, the Czech Republic, and Estonia below), data was not reported in the latest EBRD report. Thus, I relied on the most recently available report in which data was actually provided.

Sources: EBRD Transition Reports, 2002, 2003, 2004, 2005 (London: EBRD). Data for Hungary for 1993-96 comes from EBRD Transition Report, 2001. Data for Czech Republic for 1994 comes from EBRD Transition Report (1998). Data for Estonia and the Czech Republic for 1993 comes from Bert Scholtens (2000), "Financial regulation and financial system architecture in Central Europe," *Journal of Banking & Finance* 24 (525-553).

In this way, soft budget constraints would help launch the business careers of many prominent political thugs among both the plutocratic and non-plutocratic elites. The plutocrats were simply those who proved most able to exploit the best opportunities – in particular by cheaply privatizing the huge state firms whose output they had been plundering. By the late 1990s, Kuchma was ready to start privatizing the largest and juiciest segments of the old command economy. Instead of overseeing an honest privatization process that gave ownership of assets to those most able to pay for them, Kuchma made sure they were awarded to the political thugs and crony capitalists he relied on for support. Entrepreneurs were largely shut out of the process as they lacked the political influence that substituted for hard cash as the real currency of Ukraine's economy.

Crony capitalists as well as political thugs had the requisite political connections to win some of these privatizations. The combined power of political thugs and crony capitalists that resulted bode ill for the prospects that strong property rights institutions

would emerge. However, the key point for the purpose of explaining the subsequent explosion of criminal corporate raiding was that corrupt privatizations enabled *political thugs* to win. Crony capitalists tend not to resort to raiding as a business tactic; by virtue of their superior capital and business acumen, they tend to have other options available that political thugs generally do not. By putting great amounts of wealth into the hands of political thugs, fraudulent privatizations made it inevitable that raiding would become a common occurrence.

The privatizations of at least eight of the ten largest state-owned enterprises were marred by massive fraud. Often, they were awarded to the very trading companies that had managed them previously and extracted their assets through one-sided input-output schemes. With two exceptions, all ten of the biggest privatizations occurred from 2000 to 2004 while Kuchma was President.

The sales documented below are mostly presented in order from largest to smallest, ranked according to a firm's total revenues in the year prior to the privatization multiplied by the percentage sold. Because it is the individual privatizations and not the companies themselves that make up the rankings, in some instances the same firm might show up twice among the top ten. A full list of the indicators of fraud I used to analyze these privatizations is included in Appendix I. It is broken down according to those that are sufficient by themselves to indicate fraud and those that, while suggestive of fraud, are not sufficient on their own to draw such a conclusion.

The two biggest privatizations both featured the sale of stakes in Kryvorizhstal, Ukraine's largest steel manufacturer. The first was clearly corrupt while the second would occur under remarkably fair and transparent conditions. The initial privatization took place in 2004. It drew interest from a number of foreign and domestic firms. However, the State Property Fund (FGI) imposed the arbitrary requirement that the buyer had to have produced at least one million tons of coke during each of the previous three years. Not only that, the coke had to be produced within Ukraine, not anywhere else. This limitation had the effect of excluding all candidates except for a consortium led by Kuchma-allied oligarchs Viktor Pinchuk and Rinat Akhmetov (both were parliamentary deputies and Pinchuk was the President's son-in-law). The consortium paid only \$800 million. This was lower than other interested parties claimed they would have paid and far lower than the price ArcelorMittal ended up paying for the plant in its reprivatization only a year later.¹⁴

The latter privatization, in 2005, was indeed conducted honestly and transparently (the bidding actually took place on public television). It was highly anticipated and very closely watched both within and beyond Ukraine. Given that it would take place under fair and competitive conditions, most of the usual suspects - nine in all - withdrew their names from participation. This left only three that chose to take part, including ArcelorMittal, the eventual winner.¹⁵

¹⁴ "Krivorizhstal: val po planu," *Zerkalo nedeli*, 28 May 2004; "Krivorizhstal: prezidentskaya premiya," *Zerkalo nedeli*, 18 June 2004; "Krivorizhstal ostalas ukrainskoy," *Delovaya stolitsa*, 21 June 2004; "Krivorizhstal ne dostanetsya nikomu," *Kommersant*, №29 (3113), 18 February 2005.

¹⁵ "Krivorizhstal dostalas Mittal Steel za \$ 4,8 billion," *Newsru.com*, 24 October 2005; "Krivorizhstal ozhidaet esche odna reprivatizatsiya," *Ukrainskaya pravda*, 21 October 2005; "Mittal zaplatil po schetam," *Investgazeta*, №48, 27 November 2005.

The 2010 privatization of Ukrtelecom, the state telephone monopoly, was marked by similar levels of fraud. After arbitrary restrictions prevented practically all interested parties from participating, the auction drew only one bidder, an obscure Austrian-registered company called EPIC Invest. Serving up a giant middle finger to the excluded candidates as well as the people of Ukraine, EPIC's winning bid was a mere 10 UAH (that is, a couple of US dollars) above the asking price. Later, in 2013, Rinat Akhmetov's System Capital Management (SKM) bought Ukrtelecom from EPIC for an undisclosed amount. Oleksandr Ryabchenko, the head of the FGI, believes EPIC sold Ukrtelecom to Akhmetov for less than it paid in the privatization, prompting some to wonder if the eventual sale to Akhmetov had been the whole idea from the start.¹⁶

In 2001, Zaporizhstal was sold in an auction with bizarre eligibility restrictions that had nothing at all to do with economic rationality. For instance, a participant had to have supplied the plant with no less than 700,000 tons per year of iron ore or 400 tons of scrap metal during the previous year. The winner, not surprisingly, was a consortium led by four insiders and plutocrats-to-be. These included Vasily Khmel'nitsky (a shareholder and deputy from the ruling Party of Greens) and Andriy Ivanov (head of the supervisory board) as well as Eduard Shifrin and Oleksandr Shnaider. All had previously benefited from one-sided transactions with the firm while it was under state ownership. The amount they paid for their 93 percent stake barely exceeded the obscenely low starting price of \$70 million.¹⁷

Azovstal, one of the largest steel rolling manufacturers in Ukraine, came on the auction block in 2000, when 20 percent was sold to its own management. Given the kinds of scoundrels who ended up winning, this observer has his suspicions that the privatization may not have been entirely clean. Nevertheless, aside from the insider status of the winners, there were no other objective indications that the privatization was fraudulent. A clearer case of privatization fraud was the 2003 sale of a further 25 percent in the same company. A portion was sold to a firm whose identity and owner were not disclosed by the Donetsk stock exchange, where the privatization took place. The rest was sold a month later to a group of companies owned by a Deputy Prime Minister,

¹⁶ "History of Ukrtelecom," Official Internet site of Ukrtelecom, Ukrtelecom.ua; "Ukrtelecom v byudzhet 2001 uzhe ne vpisyvaetsya," *Den'*, №217, 5 November 2000; "Komu Ukrtelecom-byistro-byistro," *Ukrainskaya Pravda*, 23 July 2001; "Ukrtelecom nikomu ne nuzhen?," *from-ua.com*; "Pravitelstvo planiruet vyistavit Ukrtelecom na privatizatsiyu v marte," *UNIAN*, 4 February 2009; "SCM dozvonilis do Ukrtelecoma," *Kommersant Ukraina*, №92 (1795), 06 June 2013; "Ukrtelecom povtorit dolyu Krivorizhstali?" *Ekonomichna Pravda*, 19 January 2011; "Privatizatsiya Ukrtelecoma zavershilas," *Delo*, 19 May 2011; "Ukrtelecom" poluchil za I polugodie 125 mln grn chistoy pribyli," *Zerkalo nedeli*, 25 July 2012.

¹⁷ Heidi Brown & Nathan Vardi, "Man of Steel," *Forbes*, 28 March 2005; "Zaporozhstal: stavka na professionalism," *Zerkalo nedeli*, 14 January 2000; "Zaporozhstal uluchshaet pokazateli blagodarya novym metodam upravleniya," *Kompanon*, 30 April 2000. "Odin za vseh," *Kontrakty*, №13, April 2006. "Prodazhnyie hroniki "Zaporozhstali," *Hroniki i kommentarii*, 13 July 2011; "FGI ob'yavil konkurs po prodazhe Zaporozhstali," *Korrespondent*, 5 September 2001. "Nachalas' "perepis" bolshinstva. Pervyy v spiske - oppositsioner. A pravyye sobrali million za Yuschenko," *Ukrainskaya pravda*, 4 April 2001. "Chechetov kommentiruet isk IK "Tekt" k FGIU otnositelno prodazhi OAO "Zaporozhstal," *Finance.ua*, 18 February 2002.

Vitaly Hayduk, along with his business partners, Serhiy Taruta and Rinat Akhmetov. The absence of competitive conditions guaranteed the outcome in advance.¹⁸

In May 2003, a 25 percent stake in Nikopol Ferroalloy Plant, the world's second largest producer of manganese alloys, featured arbitrary restrictions on eligibility; any participant had to have at least three years of experience managing a ferroalloys plant in Ukraine and already be producing at least 350,000 tons of ferroalloys per year. As a result, none of the many interested buyers were able to take part - that is, except for one company that happened to have been managing the plant since 1999. This company was controlled by Viktor Pinchuk, Kuchma's son-in-law and a parliamentary deputy, who simultaneously received the right to manage the state's 25 percent-plus-one share.¹⁹

The privatization of the Nikolayev Alumina Plant in March 2000 involved similar signs of fraud. Many companies, both foreign and domestic, were interested in buying Nikolayev but were deterred by the extremely high investment obligations stipulated by the privatization rules. The obligations were imposed despite the fact that the firm was already profitable and, thus, not likely in dire need of a huge capital investment. In the end, it was sold to a company controlled by Russian oligarch Oleg Deripaska, who proceeded to not fulfill the investment obligations to which he had agreed in the first place. Deripaska was connected to Kuchma through his alliance with Ukrainian oligarch Oleksandr Yaroslavsky and was rumored to have helped finance Kuchma's presidential campaign in 1999.²⁰

In June 2000, oil refinery LiNOS was put up for sale. The tender attracted a number of interested participants but two of these were ruled ineligible. All of those that remained were very likely linked to Russia's TNK. So what appeared to be a competitive tender in all likelihood featured only one effective bidder. There was also clear political interference in the privatization from the Russian government, who actively pushed for

¹⁸ "Azovstal," *Liga.Dose*, 15 January 2000; "OAO 'Azovstal' zavershilo rekonstruktsiyu kislorodnogo bloka," *Ukrainskiy Finansoviy Server*, 23 October 2000; "Vo vtorom po velichine gosudarstve SNG est' svoi milliardery," *Nezavisimaya gazeta*, 29 September 2003; "Privatizatsiya po-ukrayinski, yak vono bulo: Azovstal," *Istorii Investirov*, 5 July 2012; "FGIU prodal poslednie 23,11% aktsiy 'Azovstali,'" *Elektronni visti*, 13 March 2003. "Donetskaya kompaniya 'Keramet Invest' priobrela 23,1% 'Azovstali' za \$19,37 mln," *RBK*, 13 March 2003; "Gayduk Vitaly Anatolevich," *LigaBusinessInform*, 30 June 2011; "Hozyaeva Donbassa: SKM – ot ISD k UPTK," *Sprava.civicua.org*; "Ahmetov poglinae svoiyh! Navischo?" *Ukrayinska pravda*, 8 June 2003; "Sergiy Taruta: Lazarenko perekonav Kuchmu, scho potribno postaviti Yanukovicha," *Ukrayinska pravda*, 11 February 2013.

¹⁹ "Nikopolskiy zavod ferrosplavov posle kapremonta zapustil ferrosplavnuyu pech №16," *Novosti ryinka tsvetnyih i chernyih metallov*, 25 March 2005; "Informatsiyne povidomlennya fondu derzhavnogo mayna," *Investgazeta*, № 9, 5 March 2003; Tri primera rezonansnyih prodazh strategicheskikh ob'ektov," *Sverh Kapital*; "Kak privatizirovali Nikopolskiy zavod ferrosplavov," *Gazeta "Kommersant Ukraina"*, 20 July 2005; "205 million v polzu Chechetova," *Investgazeta*, №22, 3 June 2003; "Oligarhi i blagotvoritelnost," *Ekonomicheskaya pravda*, 31 May 2013; "Igor Kolomoyskiy," *Dose, LigaBusinessInform*, 20 April 2007.

²⁰ "Modernizatsiya Nikolaevskogo glinozemnogo zavoda," *MetallIndeks*, 22 February 2012. "Informatsiyne povidomlennya," *Investgazeta*, №7, 17 February 2002; "Reprivatizatsiya po-ukrayinski," *Gazeta 2000*, 18 March 2005; "Borba rossiyskikh oligarhov na novom etape ukrainskoy privatizatsii mozhnet obostrit situatsiyu na strategicheski vazhnyih predpriyatiyah," *Kompanon*, 20 February 2000; "Ukraina pomogla Rossii zakonchit alyuminievuyu voynu," *Zerkalo nedeli*, 7 April 2000; "Sekrety uspeha Aleksandra Yaroslavskogo," *Forbes Ukraine*, № 11, November 2012; "Deripaska Oleg Vladimirovich," *Public internet-library of Vladimir Pribylovskiy*.

LiNOS to be sold to TNK. In addition, there were reports that the factory had suffered massive siphoning before the privatization in order to drive down the price.²¹

DneprAzot, a producer of mineral fertilizers, came on the auction block in 2003. Unusually for Ukraine, the rules of the privatization did not unduly restrict competition. Nevertheless, the privatization itself was carried out with a complete lack of transparency. The State Property Fund refused to disclose any information on the identities of the participants, the starting price, or the bids that were offered. The ultimate winner, Energoinvest, was controlled by Ihor Kolomoisky, one of Ukraine's richest businessmen and a close ally of President Kuchma at the time. His Pryvat Group had already controlled a majority of DneprAzot before the privatization through a web of Cypriot companies.²²

Of the ten largest privatizations in post-communist Ukraine, then, eight were clearly marred by indications of fraud. These included Kryvorizhstal (June 2004), Ukrtelecom (March 2011), Zaporizhstal (October 2001), Azovstal (March 2003), Nikopol Ferroalloy Plant (May 2003), Nikolayev Alumina Plant (March 2000), LiNOS (June 2000), and DneprAzot (May 2003). With the exception of Ukrtelecom, all of these privatizations took place during Kuchma's second term as President. Only two privatizations - the reprivatization of Kryvorizhstal in 2005 and the 2000 privatization of Azovstal - cannot be deemed fraudulent according to the definition used in this study (see Appendix I for a list of the indicators used).

Had Kuchma and his ex-communist cronies faced a vigorous and well-organized parliamentary opposition, they might have thought twice about engaging in such naked and visible corruption. Alas, the opposition never posed any serious threat to the party of power. In fact, the 1998 and 2002 parliamentary elections demonstrated Kuchma's ability to manufacture, through bribery and blackmail, all of the parliamentary acquiescence he needed to carry out the privatization process as he saw fit.²³ Most Ukrainian political parties cannot really be called political parties at all, at least not in comparison with the kinds of stable, ideologically distinctive mass-organizations that exist in many other European countries. Instead, they have tended to serve exclusively as vehicles for promoting the political interests of their wealthy business backers.

²¹ "OAO 'LiNOS': nakanune privatizatsii," *Investgazeta*, №22, 2000. "S dolgami 'LiNOS' ne prodats'!," *Zerkalo nedeli*, 2 June 2000. "Privatizatsiya 'LiNOSA': potentsialnykh pokupateley uzhe pyatero," *Zerkalo nedeli*, 16 June 2000. "Alternativyi rossiyskim investoram 'LiNOSA' net," *UNIAN*, 6 June 2000. "Dogovor o prodazhe 'LiNOSA' bude podpisal 11 iyunya v prisutstvii Yuschenko," *Samarskaya gazeta*, 27 June 2000. "Povernennya Lisichanskogo NPZ – nagalna neobhidnist dlya zahystu interesiv natsionalnoyi bezpeki Ukrainy," *Internet-konferentsiya Aleksandra Galkina*, 25 February 2005. "Ukreksimnefteprodukt oprovergayet obvineniya v antigosudarstvennoy pozitsii v privatizatsii 'LiNOSA'," *Region*, 12 July 2000. "'TNK-Ukraina' investiruet v modernizatsiyu 'LiNOSA'," *Elektronni visti*, 16 June 2001. "'TNK-Ukraina' investiruet v razvitie Lisichanskogo NPZ \$7,4 mln," *Elektronni visti*, 9 April 2002.

²² "Prodaetsya blokirujushhij paket akcij 'DneprAzota'," *Elektronni visti*, 22 May 2002. "FGIU hochet neustojku za 'Dneprazot,'" *Delovaya stolica*, №27, 7 July 2003. "Igor Kolomoyskiy," *Dose, LigaBusinessInform*, 20 April 2007. "Vedomosty pryvatyzatsiy," *Investgazeta* №17, 1 July 2002. "Hozjaeva Ukrainy," *Weekly.ua*, 29 April 2010. "Neizvestnye fakty iz zhizni Ihora Kolomoyskogo," *Forbes.ua*, №9, September 2012. "Chistaya pribyl' DneprAzota za 2011 g. sostavila 563,4 mln grn protiv ubytki godom ranee," *RBK-Ukraina*, 29 February 2012.

²³ *RFE/RL Newline*, 18 March 2002; *RFE/RL Poland, Belarus, and Ukraine Report*, 26 February 2002; *ForUm*, 15 March 2002; "Yanukovych Provides a Krysha for Organized Crime," *Eurasia Daily Monitor*, 17 February 2012. For *ForUm* articles, go to <http://eng.for-ua.com>.

The parliamentary opposition in Ukraine has not proven itself fundamentally and consistently weak. This becomes evident when one examines the number of questions asked by MPs in parliament. On this score, Ukraine emerges far below Poland and Estonia. From 1998 to 2013, each deputy asked an average of 1.22 questions per year in Ukraine – greater than the 0.94 questions asked in Slovakia but far below the figures of 3.54 for Estonia and 3.78 for Poland. During the crucial 1998-2004 period, in which practically all of the ten biggest privatizations took place, the average was even lower, at 1.12. Notably, the only year in which Ukrainian MPs asked questions in numbers even remotely approaching their counterparts in Estonia and Poland was the same year in which the only indisputably honest top-ten privatization occurred. In 2005, the Orange Coalition under Yuliya Tymoshenko sold steelmaker Kryvorizhstal to ArcelorMittal. During that year, parliamentary deputies asked an average of 4.13 questions each (Table 4.5).

Weak party competition stemmed from the elite-led nature of the transition, which sapped any incentives for the most skilled political leaders of the Communist Party to turn it into a modern European social-democratic organization. Only where the communists were ejected from power in the first free elections would communist parties face an immediate imperative to transform into viable social-democratic alternatives; confronted with imminent extinction, former communists in countries like Poland and Lithuania reinvented themselves as social democrats as their only hope for avoiding permanent political oblivion.²⁴ Having never lost power in the first place, Ukraine's ex-communists would not face any electoral imperative to rally behind a single social-democratic party.

Leaving aside the lack of an electoral imperative, the failure of revolutionaries to oust the former nomenklatura weakened party competition in a second way as well. With unlimited access to power and the corruption opportunities this offered, many of the most capable political operatives of the Communist Party – those skilled enough to engineer its transformation into a viable, European-style social-democratic alternative – ended up abandoning it for greener pastures. The upshot was an unreformed party organization that would largely remain consigned to political irrelevance instead of acting as a credible force that could threaten and monitor the government. Indeed, the actual Communist Party of Ukraine did survive and was consistently elected to parliament. But its failure to abandon Marxism-Leninism limited its popular appeal to most voters aside from pensioners.

Weak party competition translated into privatization fraud by limiting the impetus for creating a vigorous, parliamentary-controlled national accounting office. The Accounting Chamber had auspicious beginnings in 1996 when the legislature managed to pass the law creating it over the veto of President Kuchma. However, Kuchma subsequently managed to persuade the Constitutional Court to remove most of the Chamber's oversight powers. In the end, its authority was limited to handing over information to law-enforcement organs in the event that it found evidence of corruption. Predictably, these organs rarely followed up on the Chamber's findings. Meanwhile, the parliament refrained from investigating the Chamber's findings. "The creation of the [Accounting Chamber] added some supervision of the financial system of the state, but it failed to develop an institutional impact of limiting dysfunctional aspects of the state –

²⁴ Grzymała-Busse.

Table 4.5. Party Competition (as measured by average number of questions asked per MP)

<u>Questions per MP (by Country)*</u>	
Estonia	3.54
Poland	3.78
Slovakia	0.94
Ukraine	1.22

<u>Questions per MP in Ukraine (by Year)</u>	
1998	0.40
1999	0.93
2000	0.65
2001	0.73
2002	0.54
2003	2.08
2004	2.51
2005	4.13
2006	0.94
2007	0.08
2008	0.38
2009	0.92
2010	0.67
2011	1.43
2012	1.18
2013	1.93
<u>Average</u>	1.22

*Average annual number of questions asked per MP

Sources: Grzymala-Busse (2007), 14; Verkhovna Rada Department of Control (Ukraine)

and hence to fulfill the fundamental *raison d'être* of an external audit institution,” according to one expert. In addition, “few parliamentarians had a real commitment to exercising their rights of budget oversight.”²⁵

A strong Accounting Chamber with the power to review privatizations and compel prosecutors to pursue any evidence of wrongdoing it found could have checked the capacity of successive presidents to engage in blatant privatization fraud. But due to the weak initiative of the country’s political parties to support such a body, Ukrainian leaders were able to dole out state companies to their cronies at pennies on the dollar.

Later, the parliament established the Special Oversight Commission to monitor the privatization process. But the body never achieved any real independence as its members were composed of parliamentary deputies appointed by parliamentary vote. This meant that the same governments that typically managed to commandeer parliamentary majorities through bribery and threats were also able to stack the Commission with their own allies. Because the parliamentary opposition was so weak, it could never manage to take control of the Special Oversight Commission in order to ensure that some accountability would be brought to the privatization process. In an exemplary instance of the fox guarding the henhouse, one of the members of this

²⁵ Verena Fritz, *State-Building: A Comparative Study of Ukraine, Lithuania, Belarus, and Russia* (Budapest: Central European University Press, 2007), 167-68.

“oversight” body on the eve of the 2014 revolution was oligarch Serhiy Klyuyev (much more on him later).²⁶

If the relationship between Kuchma and his political-thug supporters was mutually beneficial, it was also one-sided. Given the highly questionable and usually illicit nature of their activities, the new business elite remained at the arbitrary mercy of their primary patron, the President. They accordingly had to rely on the him to act as a *krysha*, or “roof,” for protection. The nature of this relationship is beautifully rendered in the following secretly-taped conversation between Kuchma and Oleksandr Volkov, former presidential advisor, parliamentary deputy, and head of an energy trading firm. In it they are heard discussing the pending parliamentary inquiry of Volkov’s allegedly illegal commercial activities:

Kuchma: What? I do not understand you. Are you really for canceling immunity [from prosecution] for members of parliament? This can't be.

Volkov: Leonid Danylovich, I will tell you honestly. Me and Bakay [Ihor Bakay, the former head of Naftohaz Ukrainy who resigned from his post in 2000 amid press reports of corruption and was elected to parliament, but lost in the next election], we understand everything very well. We are not children; we understand that for us there is only one 'immunity for deputies,' and that is you. If you're not there, everything else is nonsense.²⁷

Nevertheless, while Kuchma could easily rein in one or another faction through divide-and-rule tactics, the emerging class of political thugs had become far too powerful for Kuchma or anyone else to subdue as a whole. The particular mix of political thugs who would be in or out of power at any one time would vary greatly. Either way, however, the economic elite would remain dominated by this particular type of business actor. Whichever of its members happened to be ascendant in a given instance would have the power to install their own people in the right state positions to ensure that their interests remained protected. After all, it was they who collectively controlled most of the economic and financial resources that could make or break any political leader. This was the simple fact with which any would-be reformist government would have to reckon. Simply by responding to the political logics arising from an environment dominated by ex-communists, Kuchma had created a monster. The people of Ukraine would be left to suffer the consequences.

To sum up, the failure of revolutionaries to take power during the transition led to freely-available soft budget constraints. It also precluded any chance that an effective parliamentary opposition could emerge, which in turn allowed successive governments to fraudulently privatize Ukraine’s most valuable enterprises.

It was on the basis of widespread soft budget constraints that a new class of political thugs grew and metastasized over the economy and body politic. Political thugs have come to make up anywhere between 53 and 65 percent of the plutocratic elite. The

²⁶ “Yanukovych’s Assets: Andriy and Serhiy Klyuyev,” *Yanukovych.info* (<http://yanukovich.info/andrij-ta-serhij-klyujevy/>), accessed 11 July 2014; “Main weekly events from Infobank News Agency,” *Ukraine Today*, 10 June 2002 (<http://www.ukrainianstudies.org/aaus-list/0206/msg00015.html>).

²⁷ *RFE/RL Crime and Corruption Watch*, 23 May 2002.

prevalence of political thugs among the non-plutocratic elite is revealed by the fact that practically all raids among this group for which sufficient data is available were perpetrated by political thugs (see Table 4.1). Recall from Chapter Three the imperfect measure we must use to assess the how big the population of political thugs is among this stratum: if we know raiding is widespread, and we can see that political thugs were present in all of these raids, we may conclude with some confidence that political thugs are widespread as well.

Having built their initial fortunes by pillaging and plundering state assets, Ukraine's political thugs would soon begin pillaging and plundering private ones too. Raiding among the non-plutocratic elite has reached extreme levels; of the nine economic sectors identified in the United Nations' ISIC Rev. 4 classification that do not have substantial state ownership,²⁸ seven have witnessed at least one raid. The plutocratic elite also features an abundance of raiders, with between 35 and 45 percent having engaged in at least one raid.

The following sections document how the process outlined above unfolded in specific cases, turning first to the non-plutocratic elite and then to their plutocratic counterparts. Table 4.6 contains a list of all non-plutocratic raids and the various raiding indicators that are present in each. A later section on the plutocratic elite contains tables that break down the raids allegedly committed by the members of that group.

Fear and Loathing in the Kuchma Era

Hailing from Dnipropetrovsk in eastern Ukraine, scores of cronies from his home province followed Kuchma to Kyiv after his victory in the 1994 presidential elections. Among the most important of these was Pavlo Lazarenko. Kuchma's illicit dealings with Lazarenko stretched back to 1992 when he was Prime Minister and Lazarenko was both governor of Dnipropetrovsk and presidential representative to the region. The two colluded with the director of the Naukova state farm in a scheme to export 8400 head of cattle and pocket the proceeds. They first had to come up with the money to purchase the cattle and did so by exporting a large amount of ferrous metal courtesy of an export license from Kuchma. The cattle were then sold to a Dutch company at the inflated price of \$34 million, \$20 million of which went directly into the personal bank accounts of Lazarenko and his associates.²⁹

In May 1996, Kuchma, now President, appointed Lazarenko as his Prime Minister. Lazarenko devoted his brief term in office to making as much money as he could in the shortest possible time, which he did through raiding, the generous self-provision of soft budget constraints, and the protection of others who engaged in similar activities. In August 1996, his government issued a decree forcing agricultural producers to sell their grain, worth \$200 a ton on world markets, to the state for \$85 per ton. Of

²⁸ Recall from chapter one that, of the ten sectors that make up the High-Level SNA/ISIC Aggregation (A*10) in *ISIC Rev. 4*, I excluded one: "public administration, defence, education, human health and social work activities (O, P, Q)." The reason for its exclusion is that it often features high levels of state ownership which, additionally, may vary considerably across countries.

²⁹ The details of the deal are outlined in a United States superseding indictment. Lazarenko faced money laundering charges in a San Francisco court. See Roman Kupchinsky, "The Tractor Driver of the State (Part I)," *RFE/RL Crime, Corruption, and Terrorism Watch*, 6 December 2001.

course, Lazarenko and his cronies proceeded to export the grain themselves at an estimated profit of \$500 million.³⁰ One farmer with whom I spoke had \$10 million in grain confiscated as a result of this scheme. He only managed to get it back through the acrobatic use of personal connections extending all the way to the President's office. "That's how business is *really* done in this place," he complains bitterly. "They didn't give us money back; they had to give us grain back, because that's what they stole. But it was somebody else's grain, obviously."³¹

Because this only involved the confiscation of inventory, not the takeover of a business, it does not technically count as a raid. But this beleaguered businessman has certainly faced other actions that do qualify. One involved the attempted takeover of his bulk fuel depot in 1995 by what he would only refer to as the "Russian oil mafia." The raid featured threatening phone calls, employee reports of being followed, and thugs with AK-47s bursting into his shareholders meeting.³² Then, in December 1997, another group of raiders cleaned out his bank account and simultaneously had the state hit him with a \$5.5 million claim for unpaid VAT on imported equipment. To be sure, in most countries failure to pay VAT is a serious offense, except that in Ukraine no import VAT even existed at the time. It took the respondent nine months to straighten out the situation, during which time his business had to function without a bank account.³³

Getting back to Lazarenko, his biggest source of soft budget constraints was the gas trade. While serving as First Deputy Prime Minister in 1995, he was in charge of allocating sales quotas to private gas traders. The gas was imported cheaply from Russia and Turkmenistan and then resold at a huge markup to Ukrainian consumers. During this time, an obscure company called United Energy Systems of Ukraine (YESU) emerged out of nowhere to become the biggest importer of Russian natural gas to the country, at one point controlling a third of the domestic gas market. YESU had begun as a small family-owned cooperative established by a Dnipropetrovsk businesswoman by the name of Yuliya Tymoshenko and her husband. It was widely believed that Lazarenko himself was a major shareholder in YESU. Certainly, it was thanks to him that the company was able to establish such a dominant market position in the first place.³⁴

Table 4.6. Alleged Non-Plutocratic Raids: Confirmation Indicators

Indicator Key

<u>Indicator #</u>	<u>Description</u>	<u>Indicator #</u>	<u>Description</u>
1	Many domains	8	Direct force
2	Spontaneous public actions	9	Threats made
3	Unrelated offenses	10	State actions ruled (or suspected to be) illegal
4	Non-existent laws	11	Target is a rival of powerful interests
5	Suspicious bankruptcy / redistribution	12	#2, 8, or 9 coincides with state action
6	Repeated investigations/prosecutions	13	Illegal board meeting
7	State action in midst of political conflict		

³⁰ Raymond Bonner, "Ukraine Stagers on Path to the Free Market." *The New York Times*, April 9, 1997

³¹ Interview with Respondent #59

³² Non-Plutocratic Raid (NPR) #1

³³ NPR #2. Interview with Respondent #59

³⁴ Bonner, "Ukraine Stagers on Path to the Free Market;" Global Witness, *It's a Gas: Funny Business in the Turkmen-Ukraine Gas Trade* (London and New York: Global Witness, 2006).

		Indicators													
Raid #	Target	1	2	3	4	5	6	7	8	9	10	11	12	13	Substantiated?
1	Resp. #59 (1995)								X	X					Yes
2	Resp. #59 (1997)				X										Yes
3	Industrial Union of Donbass								X						Yes
4	KIT Limited			X											Yes
5	Gala Radio									X	X	X			Yes
6	Slavyansky Bank	X		X		X									Yes
7	Volodymyr Shandra							X	X						Yes
8	Serhiy Danylov							X	X						Yes
9	Yevhen Chervonenko							X	X						Yes
10	Golden Telecom	X											X		Yes
11	Mykolayiv Aluminum Plant							X					X		Yes
12	Starwood Zakarpattia								X						Yes
13	Farmers								X						Yes
14	Maurits Stamm								X	X					Yes
15	(American agro business)														Yes
16	Polisyntez								X				X		Yes
17	Dolmart									X					Yes
18	Kvazar													X	Yes
19	Energo											X			Yes
20	Vanco										X	X			Yes
21	Kyivgorstroy													X	Yes
22	Metalist	X													Yes
23	Valery Khoroshkovsky												X		Yes
24	Vsesvit								X	X					Yes
25	Ilyich Iron & Steel Works		X			X								X	Yes
26	Kryvorizhstal	X							X	X	X				Yes

Lazarenko also profited through a similar scheme with Itera, a Russian gas trader (set up by Russia's Gazprom to siphon assets from itself to its managers). In exchange for increased gas quotas, Itera transferred money to private bank accounts that Lazarenko controlled. Kuchma actively supported Lazarenko's business interests in the gas trade, vetoing a law in 1997 which would have transferred regulatory control over such transactions to the state accounting chamber. Lazarenko's gas operations were estimated to have netted him \$200 million per year.³⁵ Lazarenko was living large, even buying a

³⁵ Ibid.; ibid.

California mansion once owned by actor Eddie Murphy in the latter's Hollywood heyday.³⁶

Having brazenly muscled away profits from so many others, Lazarenko naturally amassed many enemies during his rise to the top. Most notably, the unwelcome foray of Dnipropetrovsk-based YESU into the province of Donetsk coincided with a string of murders there (as we will see below in the discussion of Rinat Akhmetov).³⁷ After Kuchma fired him in 1997, the jig was clearly up for Lazarenko; deprived of his political protection, he either had to leave Ukraine or face certain death. Unfortunately for him, he was arrested in December 1998 trying to enter Switzerland on a false passport and detained there on charges of money laundering. After posting bail he fled to the United States but was arrested at the border. He was later tried by a US federal court and convicted on 14 counts (six were later overturned) including conspiracy, money laundering, and wire fraud. He served four years in jail and was later released under house arrest, presumably into the comfortable confines of Eddie Murphy's mansion, but only after coughing up \$86 million in bail. Having stolen far more than that while in office, he does not have to worry about money for the foreseeable future. But he cannot return to Ukraine, where he is still wanted for his alleged involvement in the murders of a parliamentary deputy and the former central bank chief.³⁸

Lazarenko's fall opened the door for other political thugs to rise. One of these was Oleksandr Volkov, also from Dnipropetrovsk. Being that Volkov was awarded the presidential order of merit by President Kuchma for his "significant contribution to promoting the development of a market infrastructure in Ukraine," it is worth running through a list of his achievements.

During the transition he was closely involved with one of the major bosses of Kyiv's criminal underworld, Volodymyr Kisel. He also had solid connections with law enforcement dating back to Soviet times. Thanks to these connections, he became one of the key players in the commercial sphere of Kyiv during this period. This status allowed him to gain friends in the government, beginning in 1992 when he served in an advisory capacity to then-prime minister Kuchma. With Kuchma's help he was able to complete a foreign exchange transaction with state-owned Prominvestbank to his great profit and the bank's substantial loss. Among his other siphoning activities was his role in the theft of IMF credits in addition to the illicit transfer of money out of the state's Social Security Fund, headed at the time by Volkov himself.³⁹ As a result of his activities he drew the attention of Belgian police, who froze \$3m of his assets.

Volkov used Naftohaz Ukrainy, the state gas monopoly set up by Kuchma in the wake of Lazarenko's downfall, as another source of illicit soft budget constraints. His associates in this scheme included Yuri Boyko and Ihor Bakay, both from

³⁶ "The Saga of Pavlo Lazarenko," *RFE/RL Organized Crime and Terrorism Watch*, 3 July 2003.

³⁷ NPR #3

³⁸ "U.S. convict Lazarenko still sought for murder, other crimes back home," *Kyiv Post*, 23 April 2009; "Swiss Investigate the Profits from Unaccountable Ukrainian Gas Trading," *Financial Times*, 9 December 1998; "Gas Scandals Infect Ukraine Politics: Pledges to Fight Corruption Have Come to Nothing," *Financial Times*, 20 February 1998.

³⁹ "Volkov bez ovech'ei shkury," *Kompromat.ru*, 4 September 2001; "Organized Crime Prosecutions Rarely Successful in Ukraine," *Organized Crime and Corruption Reporting Project* (http://reportingproject.net/new/index.php?option=com_content&task=view&id=182&Itemid=43). Also see Rosaria Puglisi, "The Rise of the Ukrainian Oligarchs," *Democratization* 10, no. 3 (2003): 122 (fn. 80).

Dnipropetrovsk, who headed Naftohaz at different times after its establishment in 1998. These three would become key members of the strategic constituency of allies Kuchma would cultivate by providing soft budget constraints to their trading companies.

Global Witness characterized Naftohaz as “a financial black hole run more for the interests of the elite than the state and its customers.”⁴⁰ Bakay’s exploits at Naftohaz are legendary. As Kuchma himself admitted, “Bakay is a talented manager, but, he, how can I say, sometimes does not know when to apply the brakes.”⁴¹ Take the following secretly recorded conversation between Kuchma and Mykola Azarov, head of the State Tax Administration:

Azarov: “Well about this Naftohaz. I invited Bakay, as we agreed, and showed him everything. My people worked on that and I trust them...And I literally told him, ‘Well, Ihor, you have put at least a hundred million in your pocket, at least. I understand, of course, that I will not expose you. I give you two weeks, a month at maximum.’ Here I showed him all the plans. ‘Destroy all the papers that witness directly or indirectly about all...You did everything stupidly and senselessly.’ And I showed him that he was doing everything stupidly and senselessly...It was possible to do it wisely. But no, he did it in such a way that any stupid inspector could figure out the underhanded schemes.”

Kuchma: “I told him: ‘Listen, my dear, we will not protect your ass forever’.”⁴²

Before Naftohaz, Bakay had already made a fortune at Respublika, a private gas trader involved in the supply of Turkmen gas to Ukraine in the mid-1990s. The government commissioned Respublika, under Bakay’s stewardship, to transfer \$275 million in cash and \$580 million in goods to Turkmenistan in order to pay off the state’s gas debts. The money went to Respublika and promptly vanished, serving as a giant subsidy to whomever ended up as the final destination for the cash. Bakay was rewarded for his role in this fiasco with the chairmanship of Naftohaz Ukrainy. While at the helm of Naftohaz, Bakay profited from the illegal siphoning of gas from Russian pipelines, complex barter deals between Naftohaz and companies that bought its gas, and the import and sale of gas to Ukrainian consumers in practices that benefited private traders while offloading the costs onto the Ukrainian state. He also moved Naftohaz funds through a web of fictitious companies using the services of a Kyiv investment bank called UkrGazBank in which Bakay himself was a shareholder. By Bakay’s own admission, Naftohaz had accumulated debts of \$760 million by the turn of the millennium despite holding a monopolistic position in the gas market.⁴³

⁴⁰ Global Witness, *It's a Gas: Funny Business in the Turkmen-Ukraine Gas Trade*, 22.

⁴¹ *Ibid.*, 25.

⁴² Taken from the Melnychenko transcripts: “English-language translation of new tapes released by former SBU officer Melnychenko,” *Kyiv Post*, 30 January 2001 (<http://www.kyivpost.com/content/ukraine/english-language-translation-of-new-tapes-releas-6-7200.html>).

⁴³ Global Witness, *It's a Gas: Funny Business in the Turkmen-Ukraine Gas Trade*, 25, 33-34.

The business actors noted above are all “official” political thugs, having used the powers granted them in their official state roles to acquire wealth. Another such example is Volodymyr Shcherban, who went after a number of businesses while serving as governor of Sumy province. During his two terms in office, from 1999 to May 2002 and November 2002 to January 2005, he is alleged to have brought down the force of the state against local businesses for the benefit of certain Donetsk business groups. A fierce Kuchma loyalist, he subjected one business, KIT Limited, to constant harassment by the tax authorities for opposing a presidential decree to combine three local academies into a single institution. A criminal case against the owner was also launched.⁴⁴ Shcherban fled to America after the Orange Revolution but was extradited back to Ukraine on charges of abuse of power, blackmail, and financial fraud involving millions of hryvnya.⁴⁵ Upon his involuntary return he voiced his hope that certain “friends” of his, including future President Yanukovich along with several Donetsk-based oligarchs, would assist him in his impending legal fight. They duly obliged once the political winds changed and in March 2007 the General Prosecutor’s Office announced that the charges against him would be dropped.⁴⁶

Another official political thug, although not one who has been implicated in raiding, is Yevhen Marchuk, a former Defense Minister, intelligence chief, and onetime Prime Minister. He allegedly controlled Ukrspetsexport, the state arms trading monopoly engaged in the lucrative export of arms to war-torn countries such as Croatia, Liberia, and Iraq. In addition, through his alleged role in Ukrtransnafta he was reported to have controlled the bulk of the oil transit flows through Ukrainian territory. He was closely connected to the Social Democratic Party-united, one of the main parties that supported Kuchma throughout his presidency.⁴⁷

The criminal corporate raids noted above are hardly the only ones perpetrated by the various political thugs assembled around Kuchma. In one case, an American businessman named Joseph Lemire faced intimidation and threats for attempting to fight the government’s decision to revoke the license of his radio station, Gala Radio.⁴⁸ The license, according to Lemire and Western diplomats, was subsequently transferred to a rival station controlled by government officials. An arbitration court later deemed this move illegal.⁴⁹

Another victim was Slaviansky Bank.⁵⁰ In the late 1990s, a number of these businessmen secured loans of over \$100m from Slaviansky, Ukraine’s most profitable and well-managed bank at the time. They did not wish to repay these loans. In addition, Slaviansky had been taking business away from other prominent banks connected to presidential allies. If that were not enough, Kuchma suspected that the bank was helping to finance the business empire of Yuliya Tymoshenko, the head of YESU and a

⁴⁴ NPR #4

⁴⁵ Ihor Yatsenko, "Former Sumy governor Volodymyr Shcherban detained in the United States." *FirsTnews*, October 14, 2005.

⁴⁶ Pavel Korduban, "Former and Current Ukrainian Interior Ministers Ready to Confront Each Other." *Eurasia Daily Monitor*, March 21

⁴⁷ Kost Bondarenko, "Ukraine's Oligarchs Emerge from Soviet System." *Kyiv Post*, April 4, 2002; *RFE/RL Crime and Corruption Watch*, 28 March 2002, 19 April 2002, 25 April 2002, and 16 May 2002.

⁴⁸ NPR #5

⁴⁹ Bonner, “Ukraine staggers...”

⁵⁰ NPR #6

prominent opposition leader. It was this fact, in particular, that evidently had Kuchma so peeved: “Fuck your mother!” an irate Kuchma exclaimed into the tape recorder of which he was not yet aware, “Get Slaviansky Bank! This kike must be the first to fall. And, as the saying goes, let all of Ukraine know!”⁵¹

Taking their cue, the General Prosecutor’s Office in March 2000 jailed the bank’s majority shareholder, Borys Feldman, on charges of income tax evasion, misuse of office, and embezzlement. The National Bank of Ukraine suspended Slaviansky’s banking licenses while the State Tax Administration confiscated its assets and sold them off at under ten percent of their value. Feldman was later freed and most of the charges were overturned, but not after seeing his business taken from him and spending four years in prison to boot.⁵²

Feldman and his bank were alone in suffering the retribution of the Kuchma administration for supporting the opposition. Many other businesspeople faced the prospect of imminent extinction at the hands of the government as a result of their political activities. As Marchuk, the state intelligence chief, noted, “If [your business is] loyal to the authorities, they will ignore or overlook anything. If you are disloyal, you or your business will be quashed immediately.”⁵³ When the 2002 parliamentary elections failed to deliver a clear majority for the President, government allies undertook an epic round of intimidation and blackmail to bring enough deputies over to his side. Conveniently for the President, many of these deputies owned private businesses and were thus especially vulnerable to pressure. This strategy had the effect of raising the main pro-presidential party’s share of the seats from 102 immediately after the elections to 182 a few weeks later.⁵⁴

According to Socialist Party leader Oleksandr Moroz, parliamentarians were invited to meetings at the General Prosecutor’s Office, where they were “discreetly warned that [prosecutors] have dossiers on all deputies.”⁵⁵ Volodymyr Shandra reported threats made against his multimillion dollar roofing business in the event that he failed to join the pro-Kuchma faction in parliament. He also faced a criminal investigation for alleged financial irregularities along with the seizure of computers and documents.⁵⁶ Serhiy Danylov, owner of the publishing house that published the autobiography of opposition-leader Yuliya Tymoshenko, endured over 100 visits to his business by the tax authorities, who also warned his clients against doing business with him. His firm nearly collapsed and he had to cut his workforce dramatically.⁵⁷ “I can say that the KGB in 1988 was much kinder than the tax administration of Ukraine today,” he complained.⁵⁸ Parliamentary deputy Yevhen Chervonenko, owner of a trucking firm, was similarly

⁵¹ Plenki Mel’nichenko v dele bankira,” *Kommersant*, 20 May 2004. Available at <http://www.kommersant.ru/doc/475906>.

⁵² Ibid.. Also see *RFE/RL Organized Crime and Terrorism Watch*, December 27, 2001; *RFE/RL Crime, Corruption, and Terrorism Watch*, 27 December 2001.

⁵³ Viktoria Braychenko, ““Kyiv Restaurants Accuse Authorities of Harassment”.” *Kyiv Post*, November 18, 2004.

⁵⁴ *RFE/RL Newslines*, 18 March 2002; *RFE/RL Newslines*, 26 April 2002; *RFE/RL Newslines*, 21 May 2002; *RFE/RL Crime and Corruption Watch*, 30 May 2002.

⁵⁵ *RFE/RL Newslines*, 21 May 2002.

⁵⁶ NPR #7

⁵⁷ NPR #8

⁵⁸ Sharon LaFraniere, “Scare Tactics On the Rise In Ukraine.” *Washington Post Foreign Service*, December 17, 2002.

harassed by the tax administration for supporting Yushchenko. The agency froze his company's bank accounts and seized its trucks, costing the firm over \$1 million in lost revenue.⁵⁹ "I was an adviser of the President," he said. "I was a minister. When I was there, they did not touch me. But since I began to support Yushchenko . . . I am being told I will lose everything."⁶⁰

According to Yushchenko, two dozen companies linked to Our Ukraine, his political party, found themselves on the verge of extinction in the period surrounding the 2002 elections. It continued in the run-up to the 2004 presidential election, when a number of restaurants faced government harassment allegedly for their support of Yushchenko.⁶¹

Under Kuchma, the powers-that-be were ruthless in pursuing his and their opponents and would not shrink from ordering their murders. They nevertheless tried to maintain appearances by stage-managing the assassinations using a number of methods. "Suicides" were common and were conveniently timed to occur at certain politically expedient moments. Matters became especially intense during the period surrounding the election of Viktor Yushchenko, the opposition candidate, to the presidency in late 2004 and early 2005. Yury Lyakh, head of the Ukrainian Credit Bank, was one prominent figure who "committed suicide" during that time. On March 4, 2005, the very day he was to give testimony at the General Prosecutor's Office, Yury Kravchenko, Kuchma's former Interior Minister, committed suicide by shooting himself in the head – twice.⁶²

Another favorite method was the *kamaz*. Taking its name from the large freight trailer frequently used to transport agricultural goods and other products, it involved having the truck suddenly back its trailer out into the street just in time for the assassination target to crash into it. The rig was situated just high enough to take off the upper part of the car at the level of the driver's head, thereby decapitating the victim. Plausible deniability could of course be maintained since the killing would appear to be an unfortunate accident. Vyacheslav Chornovil, head of Rukh, an opposition party, was killed in this manner.⁶³ In addition to suicides and the *kamaz*, there was the "freak hunting accident," a fate which befell Yevhen Kushnaryov, a major figure in the Party of Regions.⁶⁴

While many raids were politically motivated, plenty of others were done purely for profit. Another hostile takeover under Kuchma targeted Golden Telecom, a private telephone services provider that began competing with Ukrtelecom, the state provider, in 2001.⁶⁵ The General Prosecutor's Office subsequently launched a criminal investigation of Golden Telecom on behalf of Ukrtelecom, and in 2002 the company was subjected to over 50 raids by government agencies.⁶⁶

⁵⁹ NPR #9

⁶⁰ LaFranier, "Scare Tactics..."

⁶¹ Braychenko, "Kyiv Restaurants..."

⁶² "Ukraine: Battle Against Corruption Grinds to a Halt." *RFE/RL Organized Crime and Terrorism Watch*, 3 October 2005.

⁶³ Interview with Respondent #14

⁶⁴ Interview with Respondent #63

⁶⁵ NPR #10

⁶⁶ *Kiev Post*, 7 March 2002; *RFE/RL Crime and Corruption Watch*, 25 October 2002.

Another attempted raid during the Kuchma era targeted the immensely valuable Mykolayiv Aluminum Plant (MAP).⁶⁷ The plant controls a vital link in the supply of aluminum throughout the former USSR and has long been eyed by various companies wishing to acquire it. In this particular instance, the government was considering selling a significant stake in the company to a consortium that included the UK-based Trans World Group (TWG), Siberian manufacturing group SIBALCO, and Odessa-based Iren (which was linked to TWG).⁶⁸ TWG had been the key protagonist in Russia's notoriously violent "aluminum wars" in the mid-1990s. It served as the vehicle through which future multibillionaire Oleg Deripaska and the underworld-linked Chorny brothers took control of the aluminum industry in Russia's Krasnoyarsk region.⁶⁹ TWG and firms linked to it had been trying to get control of MAP for years, mostly by lobbying the Ukrainian government to privatize its remaining stake. But Vitaly Meshyn, the plant's director, fiercely resisted these attempts. In the fall of 1998, Meshyn was in negotiations with a potential partner from Tajikistan to give sell it a stake in MAP. This apparently proved too much for the plant's Russian suitors. Leaders of the Ukrainian Communist Party began pushing in parliament for Meshyn's removal while the government initiated plans to sell part of the plant to a Ukrainian firm thought to be closely tied to TWG. In the midst of these heated developments, the State Security Service (SBU) announced an investigation of MAP's management for alleged smuggling and tax evasion. Meshyn and two of his deputies were arrested. Police swarmed on the plant, seizing documents and sealing off the offices of the other managers while proceeding to search their homes.⁷⁰

Clearly, then, Kuchma had no problem with arbitrary rule and extortion. But he did act to prevent the concentration of the instruments of arbitrary rule and extortion from falling into the hands of rival power centers. In the chaos of the Kravchuk years, these powers were widely distributed among competing nodes in society. Kuchma would change all that. One of the biggest threats from his point of view were the multitudinous criminal protection rackets that operated throughout the country during the early and mid-1990s. "They existed everywhere; it didn't matter what your trade was," said one entrepreneur who has been active in Ukrainian business since the beginning.⁷¹

One of my sources, an attorney, had an unwanted run-in with the Savlokhov brothers, powerful racketeers in Kyiv. He was in the midst of a lawsuit against an employee of his client who had been caught stealing when it suddenly emerged that the accused employee was connected to the Savlokhov brothers. The attorney, my respondent, was paid a visit by two of the Savlokhovs' representatives who warned him not to show up at the next hearing - or else. He was only saved after a friend put him in touch with an ex-military special operative, whom I will call "Sasha." At the time, Sasha served in the elite Alfa unit of the Interior Ministry. When Sasha met with the employee who had used the Savlokhovs to intimidate my source, they realized they knew each other and so the problem was solved amicably. But while my source, the attorney, was safe, his client was not. Sasha informed the client that he would indeed get a

⁶⁷ NPR #11

⁶⁸ Nathan Hodge, "Secret service raids Mykolayiv Alumina Plant." *Kyiv Post*, December 11, 1998

⁶⁹ Richard Behar, "Capitalism In A Cold Climate." *Fortune*, 12 June 2000.

⁷⁰ "The X-file on Mykolayiv Alumina Plant," *Kyiv Post*, 11 February 1999

(<http://www.kyivpost.com/content/ukraine/the-x-file-on-mykolayiv-alumina-plant-1322.html>).

⁷¹ Interview with Respondent #57.

favorable court decision that he could then take to his insurance company. But otherwise he was now a target of the Savlokhov brothers. He ended up having to leave the country for a few years.⁷²

When Kuchma came to power, he had no intention of letting such rival predatory actors operating extortion rackets interfere with his own ability to do the same. He gave the racketeers a cease-and-desist order: either give up the private protection business or leave Ukraine. Some of the racketeers did leave, often for Israel, while others stayed behind and ignored Kuchma's warning. The latter usually ended up in prison at Kuchma's behest, who simply had his police arrest them using planted guns or drugs to create the necessary legal pretext. He also purged the police and state administration of all officials who had provided protection to the racketeers.⁷³

Kuchma's methods in this war went well beyond the use of administrative mechanisms. In 1994, Ukraine witnessed an influx of Chechen criminal groups. These organizations had an especially fearsome reputation due to their violent activities in Russia and the Caucasus. True to form, they began firebombing kiosks upon their arrival in what was intended to serve as a warning to local businesses to start paying up. According to one of my sources, Kuchma dealt with this problem in his own unique way; he had Alfa special forces officers start killing them. Those who survived got the message and left the country. Suffice to say, within a year of launching his initiative "the country didn't have any more racketeers."⁷⁴

This did not mean that the business community was now free from the obligation to pay off the powers-that-be. The demands for protection money would now come from state officials themselves, linked in a hierarchical web of patron-client ties leading all the way up to the President. "Today, if somebody wants to extort money," said one respondent, "he has to be in an official state position." The typical business owner now pays the head of the local police, the prosecutor, or a court official to serve as his *krysha* ("roof"). A more prominent businessperson might rely on someone from the Security Service of Ukraine (SBU), the state intelligence agency. If someone happens to face demands for protection money from a non-state racketeer, he can simply go to the head of the local Interior Ministry branch, report his problem, and ask for protection. But it will now be the Interior Ministry official who will serve as his *krysha* instead of the racketeer. Not that this is necessarily any better for the business owner. My source describes what has become the new normal: "Somebody approaches a businessman and says, 'sell me your business.' And if he doesn't agree to sell for the proposed sum, he will lose the business. It won't be some group of bandits. It might even be the police."⁷⁵

Fear and Loathing After the Orange Revolution

With all of the corruption that stained the outgoing Kuchma administration, the presidential elections of 2004 were met with high hopes - and considerable trepidation at the government's response in the event that its preferred candidate lost. These fears were realized when the government falsified the results to keep its man, Viktor Yanukovich,

⁷² Interview with Respondent #14.

⁷³ Ibid.

⁷⁴ Ibid.

⁷⁵ Interview with Respondent #56.

the incumbent Prime Minister, in charge. What followed was a popular uprising against the government's efforts. In what came to be called the Orange Revolution, Yanukovich was ultimately forced to concede defeat in favor of Viktor Yushchenko, the opposition-backed candidate.

While the Orange Revolution was seen by many as heralding a new era, the most remarkable feature of the post-Kuchma period was how little things would change. To be sure, true political competition and openness returned to Ukrainian politics under Yushchenko following the long winter of the Kuchma presidency. This was due in large part to a constitutional amendment passed as part of the deal securing Kuchma's exit from power. Enacted in December 2004 during his final days in office, it amounted to a major revamping of the existing constitution to establish a French-style semi-presidential system. The President retained the right to appoint the ministers of defense and foreign affairs but relinquished to parliament the power to appoint and dismiss other members of the government including the Prime Minister. In the event that no parliamentary majority could form in the legislature to appoint a Prime Minister, the President was obliged to dissolve the parliament and call for new elections. The new amendment would take force in January 2006.

As a result of the constitutional changes, the age of top-down control by a singular Kuchma-like figure was gone, at least for the time being. Because of the reduced importance of the presidency, the prospect of relying on Yushchenko as a *krysha* was far less attractive than it had been under Kuchma (although, seemingly going to great lengths to disappoint the reformist hopes that surrounded his election, he would quite blatantly act to protect the interests of criminal businesspeople in a number of instances, as we will see in due course).

And yet, since outbreak of the Orange Revolution almost ten years ago, the essence of Ukraine's political economy has proved little different from what came before. By and large, the faces have not changed much. Nor have the tactics they use to amass wealth. Raiding has certainly declined among the long-established plutocrats; all of the major assets worthy of their takeover efforts have by this point already passed from weaker to stronger hands, and it is not worth the time or money to attempt to pry them away from those who currently control them. But the picture for the non-plutocratic elite as well as newcomers to the plutocrats (like Yury Ivanyushchenko) is different, as there still exist a plentiful supply of lesser companies to whet their appetites. Consequently, raiding is still going strong among this segment. Meanwhile, both the plutocratic and non-plutocratic elites continue to profit from soft budget constraints.⁷⁶

As such, the experience of Ukraine after the Orange Revolution demonstrates just how little changes in the structure of the political regime – even ones as monumental as those ushered in by the new constitutional amendment – actually matter in reducing economic criminality and protecting property rights.

A host of criminal investigations that were launched against Kuchma-era business elites in the wake of the Orange Revolution were quietly dropped in the ensuing years. We have already seen how Volodymyr Shcherban escaped justice for his alleged crimes. He was hardly alone. Yury Lutsenko, who served as Interior Minister after the Orange

⁷⁶ For similar views on the lack of substantive change since the Orange Revolution, see Kupatadze, 90-115; Sławomir Matuszak, *The Oligarchic Democracy: The Influence of Business Groups on Ukrainian Politics* (Warsaw: Ośrodek Studiów Wschodnich, 2012).

Revolution, gave the following answer to a journalist when asked why he did not take more action to go after corrupt state officials:

Under Ukrainian law, the Ministry of Internal Affairs is only permitted to gather evidence. The act of bringing someone to trial on criminal charges can only ever be undertaken by the general prosecutor's office. Unfortunately, in 2005 the newly elected President, Yushchenko, agreed not to remove those in charge at the general prosecutor's administration, leaving in office all those who had worked under Kuchma and Yanukovych. Because of this, those responsible for the embezzlement of billions of state budget funds, the illegal privatization of state-owned businesses, resources, and utilities and even cases of murder, went unpunished. And the general prosecutor became a member of parliament for the Party of Regions.

The Ministry of Internal Affairs did what it could: It conducted investigations into the criminal activities of former and serving government officials, from former ministers to the relatives and family members of the President himself. We did not play political games. I think that this is probably why I am now answering your questions from a high-security prison cell.⁷⁷

The lack of real action to prosecute political thugs linked to Kuchma did not bode well. Internecine struggles over access to illicit soft budget constraints continued during Yushchenko's presidency. Opposing factions in the Ministry of Fuel and Energy engaged in a battle for control over who would get to strip assets from the state energy monopolies.⁷⁸ The General Prosecutor's Office did open a criminal case against Oleksy Ivchenko. But he had been appointed after the Orange Revolution to run Naftohaz Ukrainy, the state gas company. The allegations against him ranged from the receipt of illegal bonuses and the use of chartered flights for private purposes to the illicit transfer of funds to a company he controlled. The case of Ivchenko further illustrates how the same schemes that prevailed under Kuchma continued under Yushchenko.⁷⁹

There was also a re-export scam occurring in the refined oil sector. The major refineries were bought out by Russian companies who proceeded to export the oil without paying export duties. This required buying off a multitude of top-level officials extending all the way up to Yushchenko. Among these were Roman Zhvorych, the Justice Minister, and Andriy Derkach, the head of the state nuclear energy company.⁸⁰

A remarkable battle at the State Property Fund (FGI) pitted Yushchenko against his Prime Minister and onetime ally, Yuliya Tymoshenko. Tymoshenko entered office with big plans to privatize a number of lucrative state assets to businessmen allied to her.

⁷⁷ "Yuri Lutsenko: Views From a Prison Cell," Kyiv Post, 19 July 2011.

⁷⁸ "Russian Businessmen [sic] Says He Wants to Build Value in Ukraine's Energy Sector," *BBC Monitoring International Reports*, February 1, 2006.

⁷⁹ Pavel Korduban, "Corruption Probes in Ukraine: Tables Turned." *Eurasia Daily Monitor*, March 7, 2007.

⁸⁰ Interview with Respondent #15

Among the most valuable of these was the Odessa Portside Plant. When Yushchenko issued a decree canceling Tymoshenko's plans to privatize the company, she appealed to the Constitutional Court, which ruled in her favor. She then sent the police to replace Valentyna Semenyuk, the head of the FGI, with a more congenial ally. However, upon arriving the police were forced back by presidential guards sent by Yushchenko to keep Semenyuk in her post. A leading political weekly reported "rumors" that this was really a conflict between two oligarchs for control of the plant, Kostyantyn Zhevago, represented by Tymoshenko, and Ihor Kolomoisky, represented by Yushchenko (much more about these two to come).⁸¹

Just as illicit soft budget constraints have remained common after the Orange Revolution, so has raiding. One case involved a foreign investment in the Transcarpathia region of western Ukraine.⁸² In 2006-07, a Ukrainian-Canadian named Steven Chepa invested with Ukrainian and Bulgarian partners in Starwood Zakarpattia, a factory. Shortly afterward, his partners raided the firm by selling its assets and pocketing the proceeds. In November 2009, the government Interdepartmental Commission on Counteracting Illegal Takeovers and Raids investigated the case and concluded that Chepa had indeed been the victim of an illegal corporate takeover. In an attempt to recover his assets, Chepa enlisted the help of the Minister of Justice and launched a series of successful court cases that returned ownership in Starwood to him. These actions ultimately proved fruitless. Attempting to serve an arrest order to freeze the company's property and prevent its unauthorized sale, law enforcement officials were physically stopped by security guards in the raiders' employ. This happened on six separate occasions. They finally succeeded on the seventh try in February 2010, enabling Chepa to reoccupy the factory with the help of police and private security. Nevertheless, a few days later the police officers "suspiciously withdrew" shortly before Chepa's security guards were forcibly evicted by hired thugs. According to Taras Kuzio, a noted specialist on Ukraine, "what this incident shows is the degree to which state institutions have stagnated in Ukraine. Corporate raiders can continue to ignore numerous court rulings in favor of Chepa's ownership of Starwood Zakarpattia, they can defy the government's Interdepartmental Commission on Counteracting Illegal Takeovers and Raids, ignore the Minister of Justice and police and continue to occupy the factory. The police are seemingly powerless in the face of paramilitary thugs."⁸³

The market for land in Ukraine has become a frequent object of intense and often violent competition in recent years. To begin with, real estate is one of the most frequently used means for investing and laundering money in Ukraine. And yet the purchase and sale of land is technically illegal in amounts exceeding 100 hectares, thus pushing the battle to control it into the black market.⁸⁴

The so-called "war for land" has involved many criminal corporate raids. One of these took the life of Oleg Sheremet, a lawyer who was defending the interests of farmers whose land had been confiscated as a result of a court decision. Shortly before another decision that many expected would return the land to the farmers, Sheremet was

⁸¹ Pavel Korduban, "Yushchenko, Tymoshenko Clash over Privatization." *Eurasia Daily Monitor*, April 25, 2008.

⁸² NPR #12

⁸³ Taras Kuzio, "Corporate raids show state failing business," *Kyiv Post*, 18 February 2010.

⁸⁴ Interviews with Respondents #63, #64, and #56.

murdered.⁸⁵ Another raiding victim was Maurits Stamm, a Swiss businessman who arrived in Cherkasy province in 2007 and built a successful farming operation.⁸⁶ He received a visit one day from Petro Yevych, who at the time headed the local district administration and later became chief of RosAgro, an agricultural firm. “He came together with his broad shouldered assistants and hinted that I have to hand my business over to him, or I would be in trouble.” After a second visit he ended up in intensive care.⁸⁷ Another possible raid I was not able to definitively confirm involved one of the largest Ukrainian banks that, according to my source, “pushed out an American [agricultural] operation, where they...nobody knows the deal. But the Americans are no longer there, and the bank is there.”⁸⁸

Indeed, Ukraine is perilous ground for foreign investors who lack political protection. After firing its local manager, Polisyntez, a Polish-owned maker of foamed polyurethane, suffered an arson attack.⁸⁹ Soon thereafter it was shut down by local authorities, ostensibly on environmental grounds. It was at this point that “a third of [the company’s] shares were quietly bought by a third party,” according to Dariusz Kwieciński, the Polish owner. “My partners and I realized that the dismissal, the fire, the local council ban, and the purchase of shares were not a coincidence - they are links [in] the same chain.”⁹⁰

In another case, Christina Xinias, a Greek entrepreneur who founded Dolmart, a wine distributor, fell victim to an attack by one of her own employees.⁹¹ After establishing a separate company, Sommelier, in 2006 to handle certain parts of the business, she appointed her commercial director, Anna Kalchenko, to run it. Under Kalchenko’s stewardship, Sommelier began illicitly taking business away from Dolmart, prompting Xinias to file suit against Kalchenko. She was soon paid a visit by the chief of the National Energy Regulatory Commission, who also happened to be Kalchenko’s father. Xinias was told in no uncertain terms to withdraw her lawsuit lest she face “special interference.”⁹²

Further examples abound. KM Secure is a Canadian group that owned a large stake in Kvazar, a huge manufacturer of solar equipment outside of Kyiv. Much to its surprise, in 2008 it suddenly discovered it did not, in fact, own Kvazar at all.⁹³ Instead, the shareholder’s register had been altered to give a substantial stake to two other companies based in Cyprus and Panama. KM Secure was able to get a decision from the Supreme Economic Court to reinstate it as the owner of the disputed shares. However, even after this the raiders enlisted the help of law-enforcement agencies to hold an illegal shareholders meeting that gave their own representatives control of the company. The main business qualifications of the new leadership appeared dubious, to say the least. The new CEO formerly ran a clothing factory that went bankrupt while the new chairman

⁸⁵ NPR #13. Interview with Respondent #63; “People’s Party Asking PGO To Chase Down Murder Of Its Political Analyst Sheremet,” *Ukrainian News*, 3 December 2007.

⁸⁶ NPR #14

⁸⁷ “Foreign investors endure harassment,” *Kyiv Post*, 10 September 2008.

⁸⁸ NPR #15. Interview with Respondent #57.

⁸⁹ NPR #16

⁹⁰ “Foreign investors endure harassment.”

⁹¹ NPR #17

⁹² “Foreign investors endure harassment.”

⁹³ NPR #18

of the supervisory board was the son of a deputy in the Kyiv city council. No matter; they were less interested in using the plant to produce high-tech products than in acquiring the valuable real estate on which it resided.⁹⁴

The reach of Ukraine's corporate raiders is hardly limited to foreign investors who lack the political clout to defend themselves. Viktor Nusenkis, one of Ukraine's richest billionaires, was himself victimized by an illegal takeover attempt. Beginning in the early 1990s, Nusenkis, along with his partner, fellow plutocrat Leonid Baysarov (both "red directors"), transformed a number of largely worthless state enterprises into a profitable and vertically-integrated steelmaking operation called Energo. Doing so required the help of official connections, which allowed them to receive substantial export quotas for coal and metal. In addition, any highly profitable firm that expects to survive in Ukraine is well advised to obtain the necessary political protection. It was to this end that Nusenkis, Baysarov, and Energo turned to Hennady Vasylyev, who served two terms as chief prosecutor of Donetsk in the 1990s and another as General Prosecutor of Ukraine during Kuchma's second term. His main role was to protect the firm from the multitude of political thugs swarming around it like vultures. He was widely believed and certainly claims to have been granted a major stake in Energo in exchange for his services.⁹⁵

When the Orange Revolution erupted in 2004, he had the misfortune of serving as the country's General Prosecutor and was instrumental in (the ultimately failed) efforts to ensure the election of Yanukovich. As a political thug, his primary value at Energo was his substantial influence over the levers of state power. Once he was ousted from his position, he was no longer able provide the company with political protection. Having been wise enough to avoid committing his reputed shareholding to paper while he was in office, he was disowned by Energo after losing power. However, once fellow Donetsk strongman Viktor Yanukovich became President in 2010, the time was ripe for Vasylyev to claim what he saw as rightfully his. After announcing in May 2012 that he was indeed the beneficial owner of a 50 percent stake in Energo, the State Securities Commission froze all Ukrainian assets belonging to Nusenkis. With billions of hryvnias (the Ukrainian currency) suddenly tied up from being used for ongoing business needs, Nusenkis found himself paralyzed as Energo's market capitalization dropped precipitously and lenders began besieging his companies for debt repayment.⁹⁶

Another prominent attack targeted Vanco, a multinational oil producer.⁹⁷ In 2008, the government of Yuliya Tymoshenko unilaterally revoked a contract with Vanco for oil exploration in the Black Sea. The contract had been concluded by Yanukovich, her mortal enemy and predecessor as Prime Minister. Vanco's participation in the project took place through a consortium with Ukrainian tycoon Rinat Akhmetov and two foreign companies that refused to disclose their owners (it later emerged that one of them was linked to Russia's Solntsevskaya organized crime group). Tymoshenko's stated reason

⁹⁴ "Kvazar' kloniruiut," *Invest-Gazeta*, 25 January 2009; "Baysarov Leonid Bladimirovich," *Verkhovna Rada VII Sozyva: Kto est' Kto* (<http://vybory2012.comments.ua/rada/person/Baysarov-Leonid-Vladimirovich>); A. Fedorov, "Komu prinadlezhit Ukraina. Kontsern 'Energo'," *Chetverta vlada*, (reprinted from *Invest-Gazeta*, 25 November 2002; available at <http://4vlada.net/politika-i-biznes/komu-prinadlezhit-ukraina-kontsern-energo-investgazeta-261102-afedorov>).

⁹⁵ "Krysha na milliard," *Forbes Ukraina*, 24 May 2012.

⁹⁶ NPR #19. Ibid.

⁹⁷ NPR #20

for canceling the contract was that it had been concluded through corrupt means under the previous government and ceded too much control of Ukraine's natural resources to Russian interests. Nevertheless, the unilateral revocation of the contract was illegal. Moreover, Akhmetov, a shareholder in the target firm, was an enemy of Tymoshenko. This coincidence of factors qualifies the license revocation as a criminal corporate raid.⁹⁸

Fear and Loathing in the Yanukovich Era

When Viktor Yanukovich assumed the presidency in 2010, he did so at a time when a powerful class of political thugs was already well-entrenched. This was due to the elite-led mode of transition which left the nomenklatura in control of the government and averted any chance that hard budget constraints could be imposed. Political thugs now occupied a prominent place in both the plutocratic and non-plutocratic elites. As a result, they were influential enough, as a whole, to guarantee that all important state posts would be held by their patrons.

Politics is one of life's most notoriously unpredictable domains. Nevertheless, after Yanukovich's election, this observer boldly predicted that his administration would be marked by rampant raiding and the allocation of illegal soft budget constraints. Political outcomes may be hard to predict, but given the types of characters who dominated the political and business elites, this particular one seemed a safe bet to make.

And indeed it was. Yanukovich's term in office began in suitably inauspicious fashion as he promptly ignored the 2004 constitutional amendment giving parliament the authority to form the government. Instead, he unilaterally appointed his own man as Prime Minister. This man, moreover, was Mykola Azarov, who, as tax administration chief under Kuchma, repeatedly used his position to assist in criminal corporate raids. Yanukovich and Azarov proceeded to staff the new government and presidential administration with a variety of plutocratic political thugs and their representatives.⁹⁹ One of these representatives was Yury Boyko, who had been involved in siphoning gas from Naftohaz Ukrainy while he was chairman of the state monopoly under Prime Minister Yanukovich. He now returned as Minister of Energy and the Coal Industry under President Yanukovich. In an example of feedback effects, Boyko parlayed the wealth he obtained through illicit soft budget constraints in the 1990s into still-greater opportunities to profit from similar schemes later on.

Yanukovich's administration has also jailed key figures from the previous Tymoshenko government including former Interior Minister Yury Lutsenko as well as Tymoshenko herself. In an echo of Kuchma's strong-arm tactics, the Yanukovich team also employed bribery and blackmail to force the defection of sixty parliamentary deputies to the side of the pro-presidential coalition following Yanukovich's election, according to Taras Kuzio (you can even listen to a secretly tape-recorded conversation in which a deputy was offered a bribe to join the coalition here: ostro.org/articles/article-349540/). Yanukovich and his General Prosecutor, Renat Kuzmin, also faced allegations

⁹⁸ "Ukraine, Vanco Energy, and the Russian Mob," *Eurasia Daily Monitor*, 16 September 2008; "Ukrainian government offers out-of-court settlement to Vanco," *Eurasia Daily Monitor*, 6 August 2008; "Vanco files complaint in oil deal," *Kyiv Post*, 23 July 2008.

⁹⁹ "Caretakers," *The Economist*, 12 March 2010.

of actively protecting organized crime figures such as Oleksandr Melnyk and Givi Nemsadze. The latter's gang has been implicated in over 100 murders.¹⁰⁰

To the consternation of many of the oligarchs who served in his first government, formed in 2010, Yanukovich gradually edged them out in favor of his personal Donetsk cronies, including his own relatives. This group collectively came to be known as "The Family." According to one analyst, Yanukovich's son, Oleksandr, was "fast on his way to becoming the world's second richest dentist, after Turkmen dictator Gurbanguly Berdimuhamedov." During his father's presidency, various companies he controlled won state contracts valued at upwards of 5.5 billion euros. At one point, his fortune was estimated to have stood at nearly \$200 million - and that may have been a conservative estimate at the time.¹⁰¹

Serhiy Kurchenko, another businessman who was close to the President, emerged out of nowhere to become, in the words of *Forbes*, the "Gas King of All Ukraine." The magazine identified the 27 year-old as one of the biggest oil importers in the country and tied him to gas smuggling as well. He also purchased a top soccer club, an oil refinery from Lukoil, the Russian energy major, and a company whose business model consisted of buying gas cheaply from the state and selling it at market rates to consumers. He also amassed Ukraine's biggest media empire. Kurchenko himself was suspected of being a front for Oleksandr Yanukovich.¹⁰² "I have never seen stealing on such a scale," announced Mykola Holomsha, Ukraine's new First Deputy Prosecutor-General, in June 2014. "All government agencies were corrupt from the bottom up. The state suffered total losses of around US\$ 38 billion." Of this amount, he believes, a full \$32 billion left the country along with Yanukovich's coterie of allies in the final days before he was ousted.¹⁰³ Because Holomsha clearly has an axe to grind with the previous government, his \$38 billion estimate must be taken with a grain of salt. What is certain, however, is that Yanukovich's stunningly rapid and blatant transfer of state assets to his own family suggests he was in power for the sole purpose of amassing wealth.

Yanukovich complemented the growing fortunes of his son by appointing others close to him to key government positions. Among these appointees were the central bank chief and the heads of the finance and tax ministries.¹⁰⁴ This came after a 2012 reorganization that saw Azarov continue in his post as Prime Minister while all of the other important posts went to cronies of Yanukovich from Donetsk. As investigative journalist Serhiy Leshchenko noted, "the President's 'Family'...now controls the ministries of agriculture, defense, foreign affairs, economic affairs, and natural resources and environment. In other words, key roles in the Ukrainian government are now in the hands of people from nowhere, whose chief merit is their membership in Oleksandr's mob and their loyalty to his father, the President." One of these "people from nowhere"

¹⁰⁰ "Yanukovich Provides a Krysha..."

¹⁰¹ Sergei Leshchenko, "In Ukraine, it grows on trees..." *ODRussia*, 20 August 2013; "Digging the Trenches," *New Eastern Europe*, 23 July 2013; "Dithering in Kiev: Russia Begins to Lose Patience with Ukraine," *Der Spiegel Online International*, 12 February 2014.

¹⁰² *Ibid.*

¹⁰³ Matthew Luxmoore, "Ukraine: Journalists, Prosecutors Searching For Stolen \$38 Billion," *Organized Crime and Corruption Reporting Project*, 9 June 2014 (<https://reportingproject.net/occrp/index.php/en/ccwatch/cc-watch-indepth/2479-ukraine-journalists-prosecutors-searching-for-stolen-38-billion>).

¹⁰⁴ "Digging the Trenches," *New Eastern Europe*, 23 July 2013.

was Serhiy Arbuzov who, upon being named as one of Eastern Europe's best bankers by "a non-existent German university registered in a dormitory suburb of Cologne," went from a lowly post in Oleksandr Yanukovych's small bank in Donetsk to First Deputy Director of Ukraine's central bank.¹⁰⁵

Another Yanukovych ally, Eduard Stavitsky, assumed the top position in the energy ministry. "Stavitsky's only noteworthy previous achievement," notes Leshchenko, "was the transfer of ownership of Mezhyhirya, an official government residence on a vast estate, from the Ukrainian state to a Liechtenstein trust owned by the Yanukovych family. The President now lives there in unbelievable luxury, which he owes to Stavitsky's deft handiwork."¹⁰⁶ The new head of the Constitutional Court was an obscure judge from Yanukovych's home town. During his term in office in Donetsk, key state records relating to Yanukovych's earlier prison stints for violent crimes happened to disappear.¹⁰⁷

Along with the ministries noted above, the Family also took control of the state's main enforcement arms. The Ministry of Interior came under the control of Family loyalist Vitaly Zakharchenko.¹⁰⁸ Meanwhile, the General Prosecutor's office, according to Taras Kuzio, had become "an arm of repression rather than an instrument of justice," although some may wonder whether it has ever been anything other than that. Meanwhile, much like Kuchma, Yanukovych cemented his personal control over the regions; eighty-eight percent of Ukraine's regional governors belonged to the pro-presidential Party of Regions.¹⁰⁹

With such tight control over the key levers of state power, it should come as no surprise that the names of Oleksandr Yanukovych and other members of the Family came to be associated with a host of illegal business takeovers. One of these was Kyivgorstroy, Ukraine's largest construction company.¹¹⁰ In 2009, foreign investors bought a controlling stake in the troubled company from the Kyiv city administration and started to turn it around. However, after the election of Yanukovych in 2010, it suddenly became a target. City authorities announced their intention to return ownership of the company to "the people." A court decision invalidated the privatization and handed the firm back to the state. Afterwards, an illegal board meeting was held and a new management appointed. Representatives of the foreign investors were barred from entering the meeting. According to my sources the Yanukovych "Family" is rumored to have been behind this raid.¹¹¹

The alleged victims of the Family extended all the way to the very top of Ukraine's business world and included at least two of the plutocrats. One of these, Oleksandr Yaroslavsky, decided to part with his football club, Metalist, after suffering harassment from the authorities in Kharkiv. "I had GBP 400m in the kitty, enough to keep Metalist going for ten years," Yaroslavsky complains, "and I planned to invest in

¹⁰⁵ Sergei Leshchenko, "Ukraine as Family Business," *Transitions Online*, 5 February 2013.

¹⁰⁶ Ibid.

¹⁰⁷ Leshchenko, "In Ukraine, it grows on trees..."

¹⁰⁸ Taras Kuzio, "Ukraine Sliding From Oligarchy to Cronyism," *Eurasia Daily Monitor*, 16 January 2013.

¹⁰⁹ Taras Kuzio, "Ukraine Moves to State Capitalism and 'Militocracy'," *Eurasia Daily Monitor*, 2 December 2011.

¹¹⁰ NPR #21

¹¹¹ Peter White, "Businessmen/Politicians Leave no Chance to British and European Business in Ukraine?," *24dash.com*, 6 November 2010.

new players. But then I thought - I invest all this cash and I get nothing but grief from the authorities!” The problems disappeared once he sold the club to Kurchenko.¹¹² “I don’t even know who this guy is,” says the old-time oligarch. Nor did anyone else, apparently. That did not stop Kurchenko from raising \$370 million to purchase Ukrainsky Media-Holding, a huge media empire. One might wonder how an unknown 27 year-old businessman was suddenly able to come up with that kind of money, but this is Ukraine, after all. Clearly, his financiers were not exactly treating this as an arms-length transaction as they would if they had been applying hard budget constraints on the borrower. Kurchenko also managed to persuade oligarchs Viktor Pinchuk and Ihor Kolomoisky (of whom we will have much more to say below) to part with their media assets, although it is not clear whether any of these media takeovers were criminal corporate raids.¹¹³

However, one can put this label more unambiguously on the takeover of Valery Khoroshkovsky’s media holdings.¹¹⁴ Khoroshkovsky, one of Ukraine’s richest plutocrats, initially held key positions in Yanukovich’s government. But Yanukovich and his allies presumably became upset over the reporting at Inter, Khoroshkovsky’s television channel. In December 2012 he was reportedly summoned to Yanukovich’s office for a talk. A few days later he fled to London with his family. Then, in February 2013, the sale of Inter to Serhiy Lyovochkin and gas magnate Dmytro Firtash was announced. Even though the price was thought to be well-above market, it still counts as a raid since the circumstances suggest the sale was not exactly voluntary. (I am counting this as a non-plutocratic raid despite the involvement of Firtash, who is a member of the plutocrats; the main impetus behind the takeover appears to have been Yanukovich and other members of the government, not Firtash.).¹¹⁵

In addition, Vsesvit, a respected news journal, also became the target of a raid at the hands of individuals linked to the Party of Regions.¹¹⁶ According to Mykola Riabchuk, a contributing editor at Vsesvit, a group of ruffians stormed into the Vsesvit offices (located right next to the Ukrainian parliament and Cabinet of Ministers) in April 2012. Brandishing a legal document of highly dubious authenticity, they “demanded that Chief Editor Oleh Mykytenko vacate the premises and renounce his claim to the office legally owned by the Vsesvit Publishing Company. They behaved in an extremely rough fashion, tried to damage Vsesvit property, and threatened personnel with further repercussions if they did not step down.”¹¹⁷

Two close associates of Yanukovich during his time in power were the Klyuyev brothers. Like Yanukovich, Andriy and Serhiy Klyuyev hail from Donetsk. They made their way in business in the 1990s thanks to the local patronage network Rinat Akhmetov headed. They established Ukrpodshipnik in 1992 along with Slav AG, a Vienna-registered subsidiary. The latter engaged in the trade of metal, coal, and gas, all of which

¹¹² NPR #22

¹¹³ Leshchenko, “In Ukraine, it grows on trees...”

¹¹⁴ NPR #23

¹¹⁵ Lesya Voitytskaya, “Istoria byvshego glavy SBU, starshego milliarderom,” *Forbes Ukraina*, 21 October 2013 (http://forbes.ua/magazine/forbes/1357235-istoriya-byvshego-glavy-sbu-stavshego-milliarderom#_0); Leshchenko, “In Ukraine, it grows on trees....”

¹¹⁶ NPR #24

¹¹⁷ “Raiders’ State,” *Current Politics in Ukraine*, 12 May 2012 (<http://ukraineanalysis.wordpress.com/2012/05/05/raiders-state/>).

are highly politicized and require myriad official approvals and permits. They founded Aktiv-Bank to collect money from depositors which could then be used to service the financing needs of Ukrpodshipnik.¹¹⁸ When Akhmetov secured Yanukovych's appointment as governor of the region in 1997, Yanukovych appointed Andriy Klyuyev as his deputy. In a conversation with a U.S. Ambassador released on Wikileaks, Donetsk oligarch Serhiy Taruta observed that Klyuyev "learned early that he could make money from holding a senior position, [and] now he was abusing his office for self-enrichment."¹¹⁹

One venture he pursued while serving as Yanukovych's deputy was the siphoning of assets from Vostokenerho, a power generation company.¹²⁰ Ever since their early association with him, the Klyuyevs rode on Yanukovych's coattails during his rise to power. After becoming President in 2010, Yanukovych appointed Andriy as First Deputy Prime Minister and head of a state commission to support innovative projects. While in office, Andriy took the liberty of awarding himself lucrative state subsidies and other privileges intended for the promotion of green energy. Under a program to extend preferences to energy producers relying on green technology, the Klyuyevs secured long-term agreements obligating the state to purchase electricity from plants linked to themselves at above-market prices; Ukraine offers the highest such "green tariff" in Europe, in fact. (The beneficiaries of this scheme are a web of offshore companies based in Austria, the Netherlands, Luxembourg, and Cyprus controlled by the Klyuyev brothers.) The same companies also benefitted from duty-free imports of solar panels and exemption from paying VAT. It was one of the Klyuyevs' former managers at Ukrpodshipnik, Serhiy Titenko, who became the head of the state agency that implements the green energy program, who granted these benefits.¹²¹ Special rules requiring that solar power plants obtain their supplies of gold polysilicon from Ukrainian producers effectively barred foreign competition to the Klyuyevs' operation for the foreseeable future. As it happened, the Klyuyevs privatized a local producer of gold polysilicon in 2008, when Yanukovych was Prime Minister and Andriy Klyuyev was Deputy Prime Minister. The loss-making firm only managed to survive as a result of "a huge loan [from Ukreximbank] secured by non-liquid assets (equipment) and illiquid future products to an unprofitable enterprise owned by an Austrian company." The decision to approve the loan should have come from the Ukreximbank management but was instead pushed through by the Special Oversight Council, a body appointed by the country's top politicians. To make matters worse, Andriy Klyuyev, in his position as head of a special state committee on investments, approved assistance from the state budget for payment of interest on the loan.¹²² The Klyuyevs' interests became inextricably linked to those of Yanukovych; it was Andriy Klyuyev who, as chief of the Security Council, ordered the

¹¹⁸ "AKTIVatsiya Klyueva. Inforgafika," *Ostrov*, 7 February 2012 (<http://www.ostro.org/general/economics/articles/348301/>).

¹¹⁹ Mark Rachkevych, "WikiLeaks: Nation's businessmen tell tales on each other in chats with US ambassadors," *Kyiv Post*, 14 September 2011.

¹²⁰ Interview with Respondent #133

¹²¹ "Klyuyev's solar energy companies shine brightly," *Kyiv Post*, 20 May 2011. For intricate details on the web of offshore entities through which the Klyuyevs maintain their ownership of their power plants, see "Yanukovych's Assets: Andriy and Serhiy Klyuyev," *Yanukovych.info*. Available at <http://yanukovich.info/andrij-ta-serhij-klyujev/>.

¹²² *Ibid.*

storming of Maidan Square in Kyiv in November 2013 to clear the protestors (it was this incident, more than any other, that sparked the ensuing wave of demonstrations and violence).¹²³

While siphoning accounts for most of the Klyuyevs' fortune, they have also benefited from at least one illicit takeover of a private asset. While it cannot technically be defined as a raid given that no agent of force was obviously involved, it was certainly predatory. As panic swept global financial markets in the fall of 2008, a smear campaign was initiated against Prominvestbank, one of Ukraine's largest banks. It began in August of that year as billboards began sprouting in Kyiv protesting a proposed share emission by the bank. A series of newspaper articles followed in September that raised serious questions about the bank's financial condition. Shortly afterward, subscribers of mobile telephone operator MTS in Donetsk received text messages claiming that Prominvestbank is not redeeming deposits and would soon be bankrupt.¹²⁴

The smear campaign succeeded in sowing panic among the bank's depositors, who flocked to its branches to demand their money. This prompted the central bank to place Prominvestbank into forced administration. The crisis was only resolved once Volodymyr Matviyenko, owner of 81.6 percent of the bank together with his family, agreed to sell out to the Klyuyev brothers, who had to bring in Russia's Vneshekonombank to help with the financing. Naturally, given the panic surrounding the bank, the price Matviyenko received was very low. At approximately \$150 million, it was far less than the \$2 billion offer he had received - and turned down - from an Italian bank in 2007. It later emerged that the Klyuyev brothers had been among the largest depositors in the bank. Because it is not clear that the central bank actually colluded in the takeover, the acquisition of Prominvestbank cannot be labeled a raid by this study's definition.¹²⁵

The Family is not the only faction to have benefited from raids during Yanukovich's presidency. Russian interests began flocking to Ukraine following the election of what most regarded to be a pro-Russian presidential candidate. Their aim was to seize assets and their presence became increasingly unwelcome even among the Yanukovich administration. A group linked to Russia's state-owned Vneshekonombank agreed to a deal to buy a majority in ISD Group, one of the largest steel conglomerates in the country. It was also close to acquiring Zaporizhstal, another steel plant. Whether these constituted raids is unclear.

A more obvious case of raiding was the Family's reputed takeover attempt of the Ilyich Iron & Steel Works, one of the country's flagship metallurgical enterprises.¹²⁶ Volodymyr Boyko, the oligarch who controls Ilyich, complained loudly that the attack was illegal and called on the government for protection against the raiders.¹²⁷ The attack was led by Hennady Korban, one of Ukraine's most preeminent raiders, who has conducted raids both for himself and on behalf of others. The attempted takeover of Ilyich was apparently one of his favorites; "It was well-prepared in the courts, and we found the right people at the plant who could do the right things at the right time, and

¹²³ "Dithering in Kiev..."

¹²⁴ Boris Davidenko, "Ruka Moskvyy," *Forbes Ukraina*, 15 May 2012.

¹²⁵ Ibid; "AKTIVatsiya Klyueva..."

¹²⁶ NPR #25

¹²⁷ "Ukraine sweats over Russian steel 'raiders'," *Financial Times*, 18 June 2010.

were able to convince them,” said one participant. The attack was accompanied by the circulation of fake issues of a local Donetsk newspaper claiming that Boyko had agreed to sell the plant to Russian investors. In June 2010, two individuals claiming to represent a Cyprus-registered company made it official when they announced that the factory – worth \$2 billion at the time – had been sold to the Cyprus firm for a mere \$30 million. Boyko denounced the statement as false. He also claimed that the raiders had acted with the assistance of Serhiy Velykanov, the chief of the brokerage firm that served as custodian of the shares and who allegedly transferred them to the “new owner.” In the end, however, Boyko was able to fend off the attack by turning to fellow Donetsk oligarch Rinat Akhmetov. But in return Akhmetov was able to purchase a majority stake from Boyko in July 2011.¹²⁸ (It should be noted that some believe that Akhmetov was behind the attack from the beginning.)¹²⁹

Another raid targeted Kryvorizhstal, Ukraine’s biggest steel producer.¹³⁰ Kryvorizhstal had initially been privatized to two oligarchs in a notoriously corrupt privatization under the outgoing Kuchma administration. After the Orange Revolution it was reprivatized to international steel giant ArcelorMittal in what would perhaps be the only honest large privatization in Ukrainian history. However, from the moment it took possession of the plant, ArcelorMittal started facing problems including local gangs shooting at its managers along with continuous threats from high level state officials. The real troubles began in 2010 following the election of Yanukovich as President. ArcelorMittal faced government accusations that it had failed to comply with the 2005 privatization agreement, claims which it successfully contested in court. The frequency of state inspections soared while the refusal of the State Tax Administration to pay \$288 million in VAT refunds created serious financial difficulties.¹³¹ In the end, ArcelorMittal still managed to hold onto the company thanks in part to the intervention of French President Nicolas Sarkozy.¹³²

The Plutocratic Elite: Political Thugs Ascendant

The preceding case studies dealt only with the non-plutocratic elite. They illustrated how the survival in power of the nomenklatura ensured vast opportunities to profit from soft budget constraints, thereby setting the stage for a vast redistribution of state assets to an emerging class of political thugs. The redistribution of state wealth through soft budget constraints took various forms, from informal input-output schemes to corrupt privatizations. As with the non-plutocratic elite, these same privileges helped put political thugs into a dominant position among the plutocratic stratum as well.

However, there was one additional factor that was uniquely relevant to ensuring that political thugs would constitute such a huge presence within the plutocratic elite. This was the fact that the very biggest privatizations were marked by serious fraud.

¹²⁸ Sevgil’ Musaeva & Yurii Aksyonov, “Pensionnyi kapital,” *Forbes Ukraina*, January 2012 (<http://forbes.ua/magazine/forbes/1344864-pensionnyj-kapital>); John Malone, “Ukraine’s Steel Industry Set to Go through Convulsions, Consolidation,” *Kyiv Post*, 28 May 2010; John Malone, “Russian Investors Trying to Muscle in on Ukraine’s Best Steel Mills,” *Kyiv Post*, 3 June 2010; Matuszak, 53.

¹²⁹ Interview with Yury Aksyonov, 5 December 2012

¹³⁰ NPR #26

¹³¹ “ArcelorMittal: ‘This situation can’t be considered normal,’” *Kyiv Post*, 27 February 2011.

¹³² Matuszak, 58-59.

Thanks to the weakness of party competition, the sales would present ample opportunities for corruption, a fact that would mostly exclude entrepreneurs from winning. The privatizations would instead be primarily awarded to those who had the requisite political connections. A previous section showed that at least eight of the top ten biggest privatizations in post-Soviet Ukraine showed signs of overt fraud. It also detailed the ways in which this was enabled by weak party competition.

The following section will show how the particular nature of soft budget constraints in post-communist Ukraine vaulted a comparatively large number of political thugs into the plutocratic elite. It will profile the political thugs who made it into the plutocratic ranks, showing how they attained this status thanks to soft budget constraints. Many of these individuals logically went on to adopt raiding as a business tactic. Table 4.7 contains a list of all raids allegedly committed by members of the plutocrats. Table 4.8 breaks down these raids according to the various raiding indicators present in each case.

Table 4.7 Alleged Plutocratic Raids

<u>Raid #</u>	<u>Target</u>	<u>Alleged Perpetrator</u>	<u>Pol. Thug?</u>
1	Azovstal	Akhmetov	Y
2	Servis-Invest and Skhidenerho	Akhmetov	Y
3	Obolon	Akhmetov	Y
4	Donetsk newspaper	Akhmetov	Y
5	Central Ore Mining and Processing Factory (TsGOK)	Akhmetov	Y
6	Nikopol Ferroalloy Plant	Kolomoisky, Bogolyubov, Martynov	Y
7	Wroblewski	Kolomoisky, Bogolyubov, Martynov	Y
8	Kremenchug Steel Casting Plant	Tihipko, Yurushev	Y
9	Chernomorsky Shipbuilding Plant	Novinsky	Y
10	Zaporizhzhya Aluminum Plant	Zhevago	Y
11	White Swan Shopping Center	Kolesnikov	Y
12	Poltavaoblenerho	Surkis	Y
13	Zaporizhzhya Transformer Plant	Surkis	Y
14	Prykarpattyoblenerho and Poltavaoblenerho	Hryhoryshyn	Y
15	Kyivsky Vedomosti	Surkis	Y
16	Stalknat-Silur	Ivanyushchenko	Y
17	VAB Bank	Bakhmatyuk	Y
18	Kyiv construction company	Poroshenko	?
19	Severodonetsk AZOT Plant	Poroshenko	?

Meet the Political Thugs

Any examination of Ukraine's plutocratic elite must begin with its long-reigning and undisputed champion. Rinat Akhmetov got his start in business, or what may be called business, well before the Soviet Union fell. As early as 1986 he was allegedly involved in protection rackets in Donetsk and was implicated by at least one newspaper investigation in the torture and murder of a local businessman.¹³³ (He has won libel lawsuits against such allegations in London, which until very recently was a notoriously plaintiff-friendly jurisdiction for global elites shopping for favorable libel verdicts).

Around this time, local communist party officials began forming strong links to the criminal underworld in Donetsk. Akhmetov, allegedly a major emerging figure in this world, profited from these connections. An expert card shark, he was also known to participate in card games with prominent communist notables. Indeed, he would use his card-playing prowess to help certain political factions edge out their rivals by luring the latter into games and beating them badly. Having become sudden debtors to Akhmetov, they were now vulnerable enough that his communist cronies could sideline them. His business partners at the time were two local toughs by the names of Akhat Brahin and Samson Bogdanov. Brahin was reportedly Akhmetov's mentor. The three would use their connections in the police to find out who was involved in the underground economy (all private economic activity at this time was technically illegal). They would then extort money from these traders in exchange for "protection" from local government authorities.¹³⁴

Because no revolutionary opposition managed to take power during the transition, the nomenklatura maintained control as a result. Consequently, Akhmetov and his partners were able to leverage their connections with the communist establishment into considerable wealth. When the Soviet Union collapsed, many enterprises in Donetsk were left without money, political protection, or their former links to the rest of the ex-USSR. For relief they turned to Akhmetov, Brahin, and Bogdanov, who formed a business group called ARS (after the initials of their first names). ARS benefited from lucrative soft budget constraints from local state-owned coal mines; it established exclusive rights to supply the mines with equipment and other materials at high prices while buying the resulting output at low prices.¹³⁵ Of course, the only way the coal mines could survive this arrangement was through the continual influx of fresh state subsidies.

The wealth and attendant influence Akhmetov gained as a result of his access to soft budget constraints would help him attain a dominant position in the eastern province of Donetsk. Coincidentally or not, all of his major rivals were murdered in the process. Toward the end of the 1980s, Akhmetov and Brahin partnered in various projects with local organized crime figures Yanosh Kranz and the Kushnir brothers. But there soon emerged a conflict over the Lyuks hotel, then controlled by the Kushnir brothers (and which later became Akhmetov's residence). Local prosecutors suddenly discovered that one of the co-owners of the hotel was illegally serving as a representative in the regional

¹³³ Andrei Lavrik and Yurii Sandul, "Krestnyi Syn," *Grani Plus*, 5 July 2005.

¹³⁴ Interview with Respondent #63

¹³⁵ Dmitrii Astakhov and Oleg Kalita, "'Donbassenergo': i Mertvie s Lotami Stoiat," *Ukrudprom*, 20 August 2013.

Table 4.8. Alleged Plutocratic Raids: Confirmation Indicators

Raid #	Target	Alleged Perpetrator	Indicators													Substantiated?
			1	2	3	4	5	6	7	8	9	10	11	12	13	
1	Azovstal	Akhmetov					X						X			Yes
2	Servis-Invest/ Skhidenerho	Akhmetov					X						X			Yes
3	Obolon	Akhmetov														No
4	Donetsk newspaper	Akhmetov									X					Yes
5	TsGok	Akhmetov								X					X	Yes
6	Nikopol Ferroalloy	Kolomoisky, Bogolyubov, Martynov					X		X	X		X	X		X	Yes
7	Wroblewski	Kolomoisky, Bogolyubov, Martynov								X						Yes
8	Kremenchug Steel	Tihipko, Yurushev								X					X	Yes
9	Chernomorsky	Novinsky					X									Yes
10	Zaporizhzhya Aluminum	Zhevago								X						Yes
11	White Swan	Kolesnikov								X	X					Yes
12	Poltava- oblenerho	Surkis								X	X					Yes
13	Zaporizhzhya Transformer	Surkis								X						Yes
14	Prykarpattya- oblenerho/ Poltava- oblenerho	Hryhoryshyn								X						Yes
15	Kyivsky Vedomosti	Surkis					X									Yes
16	Stalknat-Silur	Ivanyushenko									X					Yes
17	VAB Bank	Bakhmatyuk										X		X		Yes
18	Kyiv construction company	Poroshenko									X					Yes
19	Severodonetsk AZOT Plant	Poroshenko									X					Yes

Indicator Key

Indicator #	Description
1	Many domains
2	Spontaneous public actions
3	Unrelated offenses
4	Non-existent laws
5	Suspicious bankruptcy / redistribution
6	Repeated investigations/prosecutions
7	State action in midst of political conflict
8	Direct force
9	Threats made
10	State actions ruled (or suspected to be) illegal
11	Target is a rival of powerful interests
12	#2, 8, or 9 coincides with state action
13	Illegal board meeting

council. The authorities duly annulled the hotel's lease and transferred it to Akhmetov's partner, Brahin.¹³⁶

The murder of Kranz in October 1992 began a war for control of Donetsk. One assassination attempt on Akhmetov failed, as did two on Brahin. The latter was finally killed at the end of 1995. Yevhen Shcherban, another Akhmetov associate, followed in 1996. Next, a slew of people associated with the Kushnir brothers were killed and, eventually, Yevhen Kushnir himself was murdered. The official version of Kushnir's death maintained that he had been killed by his own people. But others in-the-know in Donetsk saw two possibilities: it was either revenge for the killing of Brahin or a part of a broader struggle for control of the region. Either way, Akhmetov came out on top.¹³⁷

If Akhmetov had a role in any of these killings, it has never been proven and he has never been prosecuted for them. But when all was said and done, Akhmetov emerged "with the unofficial title as the most powerful man in the region."¹³⁸

During this period, Akhmetov used his growing influence to place his cronies into key regional posts. He was able to do so precisely because of the wealth he had acquired from his access to state resources. Even before the war, Brahin and Akhmetov had enjoyed close ties to the heads of local law enforcement agencies. By war's end, however, Akhmetov's own people had been appointed as heads of the local Interior Ministry branch and prosecutor's office as well as governor of the province. Volodymyr Malyshev, who successively led the Department Against Organized Crime and the regional branch of the Interior Ministry, later became director of security at Akhmetov's business conglomerate.¹³⁹

By 1996, Donetsk enterprises began facing an unwelcome foray into the province by Dnipropetrovsk heavyweight Pavlo Lazarenko, the Prime Minister at the time. (Lazarenko is the one who bought Eddie Murphy's mansion and then ended up in a San Francisco prison). Together with his business partner, Yuliya Tymoshenko, Lazarenko was becoming extremely rich from gas trading through United Energy Systems of Ukraine (YESU). As we have already seen, Kuchma had granted YESU a monopoly on the sale of Russian gas across huge swathes of Ukraine, including Akhmetov's home region of Donetsk. The high gas prices Donetsk enterprises had to pay as a result of this monopoly threatened to push them into bankruptcy and thereby into the hands of YESU.¹⁴⁰

To meet the threat from YESU, they turned to their own local strongmen, Vitaly Hayduk and Serhiy Taruta. Both would later become plutocrats. Taruta had spent his early career at steelmaker Azovstal. In 1995 he left to establish Azovimpeks with administrative and financial backing from Donetsk governor Volodymyr Shcherban (no relation to Yevhen Shcherban, the organized crime figure whose 1996 murder is noted above). Although Taruta is a typical crony capitalist, his early business activities depended on the assistance of a number of prominent Donetsk political thugs. The business model of Azovimpeks consisted of buying metal slabs from Azovstal and selling

¹³⁶ Lavrik and Sandul, "Krestnyi Syn."

¹³⁷ Ibid.

¹³⁸ Yevgenii Dubogryz, "Ptentsy Gnesda Akhmetova," *Kontrakty*, January 2005.

¹³⁹ Lavrik and Sandul, "Krestnyi Syn."

¹⁴⁰ Dubogryz, "Ptentsy Gnesda...;" Vladimir Verbiyani, "Sergei Taruta. Istoria Biznesmena-Mechtatelia," *Forbes Ukraina*, 4 February 2013.

them to the Ilyich Iron & Steel Works, headed by another future plutocrat, Volodymyr Boyko. Shcherban handled the task of “persuading” the key parties to participate in the arrangement (there were a number of assassination attempts on key Azovstal officials in this period). This freed up Taruta to deal with the day-to-day management of the business.¹⁴¹

As the danger from Lazarenko and his Dnipropetrovsk allies grew, the Donetsk business elite united around Taruta who, together with Hayduk, formed the Industrial Union of the Donbass (ISD) to counter the growing threat. The idea was for ISD to consolidate control over the regional gas trade so as to secure the continuation of reasonably-priced supplies to Donetsk enterprises. In exchange for gas, ISD received the output of these enterprises. Participation in the arrangement was not voluntary. Volodymyr Shcherban ordered all of the enterprises to buy gas exclusively from ISD, not YESU. Those who refused faced rough justice; once again, there were several assassination attempts on various executives of Azovstal. Hayduk’s main contribution to the arrangement was to supply “administrative resources,” as he was a top-ranking official in the Donetsk regional administration (while Taruta can be considered a crony capitalist, Hayduk is a simple political thug). But the two partners needed a local man of authority to provide the necessary political protection. To fill this role, they brought in Akhmetov.¹⁴²

President Kuchma, meanwhile, had begun to sour on his former ally, Lazarenko. Concerned about the growing power of the group from Dnipropetrovsk, he was looking for a local partner in Donetsk to undercut it. He found this partner in Akhmetov and ISD. Under the terms of the new arrangement, Kuchma broke up YESU’s gas monopoly, granting ISD the exclusive right to sell gas in Donetsk and Luhansk. Meanwhile, in May 1997, Akhmetov, as part of the deal with Kuchma, secured the appointment of his own ally as governor of Donetsk, according to a diplomatic cable on Wikileaks. The new governor’s name? Viktor Yanukovich. Yanukovich proceeded to appoint ISD co-owner Hayduk as his deputy.¹⁴³

This marked the beginning of ISD’s ascent to power. Akhmetov, Taruta, and Hayduk would use their control over gas distribution in Donetsk and Luhansk to establish a highly profitable input-output scheme. It was a vertically-integrated arrangement that incorporated gas, coal, and coke into the production of finished steel and steel products. ISD would supply gas to local coal mines in exchange for coal on terms highly disadvantageous for the mines. It would then supply coal for the production of coke on similarly disadvantageous terms for the coke manufacturers and sell the coke in turn to the steel plants, again in one-sided transactions. ISD exported the finished steel at market prices. Of course, the scheme bankrupted the mines and factories. But that was the whole idea; now that they were debtors to ISD, ISD was in a position to take them over. It did so by either purchasing them from the state at rock-bottom prices or getting itself appointed as “manager” (a role that was practically indistinguishable from outright

¹⁴¹ Vladimir Verbiyani, "Sergei Taruta. Istoria Biznesmena-Mechtatelia," *Forbes Ukraina*, 4 February 2013; "Piatna na Reputatsii 'Industrial'nogo Soiuzu Donbassa' Okazalis' Krovavymi: Polnyi Spisok Zhertv Gaiduka i Taruta," *Kompromat.ru*, 16 September 2008.

¹⁴² Verbiyani, “Sergei Taruta...;” Dubogryz, “Ptentsy Gnesda...”

¹⁴³ Rachkevych, “WikiLeaks: Nation’s businessmen...;” Verbiyani, “Sergei Taruta...;” Dubogryz, “Ptentsy Gnesda...”

ownership). With the help of Akhmetov and other local strongmen, ISD managed to stave off the threat from Lazarenko, Tymoshenko, and YESU.¹⁴⁴

In 1999, when Kuchma was running for a second term as President, he concluded another deal with Akhmetov. In return for mobilizing electoral support for Kuchma in Donetsk, Kuchma would provide Akhmetov with all the “administrative resources” he needed in his commercial pursuits (“administrative resources” is the term used to denote state assistance in pursuing one’s private business ends). Additionally, Kuchma pledged \$200 million dollars of state money to aid the “restructuring” of the state-owned coal mines currently under Akhmetov’s control, with \$1 million going to each mine. It soon became clear that restructuring was not exactly what Akhmetov had in mind; according to one source, he proceeded to simply pocket the money for himself. The chief engineer of each mine was allegedly forced under threat of physical harm to sign a document stating that the \$1 million had arrived as planned when it really went straight to Akhmetov. Meanwhile, the mines were closed, destroying the surrounding communities.¹⁴⁵

An even bigger coup for Akhmetov and ISD was the 2000 privatization of Azovstal, the giant steel manufacturer. As noted earlier, they won control of the company in a rigged privatization. By that time, Akhmetov’s exploits had earned him a fearsome reputation not only in Donetsk but across the entire country. Contributing to this reputation were several assassinations and attempted assassinations of enterprise directors in the Donbass region between 1997 and 1999, all of whose enterprises were acquisition targets of ISD. While there is no evidence that Akhmetov was behind these murders, they were certainly convenient for him, and they added to his reputation as a man to be wary of. Oleksandr Bulyanda, manager of Azovstal (and Taruta’s former boss), survived two assassination attempts; after the second one he wisely resigned. In 1995, Mykola Skorokhod, director of Alchevsk Iron & Steel Works, was shot after refusing to relinquish control over the plant’s production to ISD. There was also one or more attempts on the life of Volodymyr Boyko at the Ilyich Iron & Steel Works.¹⁴⁶

Again, Akhmetov has never been formally implicated in these events. But it was certainly not his entrepreneurial aptitude that accounted for his rise to the top. “Akhmetov and his people would never actually found their own businesses. They would always simply take someone else’s business,” according to one source.¹⁴⁷ In the 1990s, for instance, Donetsk featured a number of big retail markets which brought in a lot of revenue. As my source explains it, Akhmetov would send his people to, say, the owner of the central market in Donetsk. They would offer to buy the market for \$1.5 million. If the owner refused, he would awaken the next morning to find that his market had burned down. Akhmetov’s representatives would then return with a new offer, this time for \$150,000, and it would be duly accepted. ARS was also known for buying up minority stakes in acquisition targets and then showing up at the shareholders meeting to demand that the owners agree to a new management.¹⁴⁸ In other instances, Akhmetov and his

¹⁴⁴ Verbianyi, “Sergei Taruta...;” Dubogryz, “Ptentsy Gnesda...”

¹⁴⁵ Interview with Respondent #63

¹⁴⁶ “Piatna na Reputatsii...”

¹⁴⁷ Interview with Respondent #63

¹⁴⁸ Ibid.

partners would have their cronies in the state administration harass the target into ceding control, as happened to the Kushnir brothers in the takeover of the Lyuks hotel.¹⁴⁹

In 2001, Akhmetov decided he wanted to leave ISD behind and strike out on his own - but not without taking its most profitable assets with him. He concluded a deal with Hayduk and Taruta that gave the truly valuable parts of ISD to Akhmetov's new holding company, System Capital Management (SKM). Hayduk and Taruta were stuck with the remaining ones, namely Alchevsk Steel, which at the time was in serious trouble. However, Taruta, with political backing from Hayduk, who continued to serve in prominent official roles, ended up turning Alchevsk into the most efficient steel-producer in Ukraine. But Akhmetov received the choicest pieces of property. One of these was Azovstal Iron & Steel Works.¹⁵⁰ The other was the Khartsyzsk Pipe Plant. Azovstal would go on to serve as the core of the SKM empire. Just how Akhmetov managed to persuade his former partners to relinquish their best assets is unclear.¹⁵¹ But as he went on to build his new empire at SKM, he would prove able to repeat this pattern over and over again, compelling the powerful owners of highly lucrative companies to sell out to him.

One of Akhmetov's biggest feats in this regard was his acquisition of Servis-Invest and Skhidenerho from the Klyuyev brothers.¹⁵² The Klyuyevs stood alone in Ukraine's energy industry in combining control of both an energy generation company and an energy distributor. Just why the Klyuyevs would agree to sell such a lucrative cash cow to Akhmetov is not clear, especially as they had repeatedly rebuffed similar offers from others in the past.¹⁵³ However, given Akhmetov's reputation, Hayduk, Taruta, and the Klyuyev brothers might have concluded that it would be best to let him have his way in order to avoid any trouble.

Not everyone buckled under the pressure, though. Oleksandr Slobodyan, another of Ukraine's richest businessmen, managed to fight off the attempted takeover of his Obolon brewery by Akhmetov's brewery, Sarmat.¹⁵⁴ Less fortunate was the owner of a profitable Donetsk newspaper, who was approached by individuals demanding that he sell the newspaper to Akhmetov. He was promised \$1 million for the company and that he would receive the payment from Dongorbank, which belonged to Akhmetov. In the end he received only \$100,000, but by that time Akhmetov had already installed his own management at the newspaper.¹⁵⁵ "So the company was already in Akhmetov's hands. This was a very typical scheme," says one source. "And those who did not agree to it later found themselves shot, murdered, and so on...Back then it was very dangerous to do business in Donetsk."¹⁵⁶

A similar raid targeted the Central Ore Mining and Processing Factory (TsGOK), which at the time was controlled by Pryvat, another of Ukraine's notorious corporate raiders.¹⁵⁷ In January 2003, SKM managed to buy a small stake from a shareholder.

¹⁴⁹ Lavrik and Sandul, "Krestnyi Syn."

¹⁵⁰ Plutocratic Raid (PR) #1

¹⁵¹ Verbiyani, "Sergei Taruta...," Dubogryz, "Ptentsy Gnesda..."

¹⁵² PR #2

¹⁵³ Dubogryz, "Ptentsy Gnesda..."

¹⁵⁴ PR #3. "The 30 Richest Ukrainians." Kyiv Post, June 29, 2006.

¹⁵⁵ PR #4

¹⁵⁶ Interview with Respondent #63

¹⁵⁷ PR #5

Then, in July, a Berkut unit stormed the premises of Pryvatbank, which had been serving in the capacity of the shareholder registrar for TsGOK. A heated battle followed in the courts. But in October 2003, SKM received an official court authorization to hold a shareholders meeting, thus enabling it to change the management.¹⁵⁸

Takeovers such as these instilled among Ukraine's business elite a deep fear of Akhmetov and SKM. Akhmetov had put his own representatives in control of large swathes of eastern Ukraine. Meanwhile, by 2002, his man Yanukovich headed the national government in Kyiv and was set to run for President in 2004. Increasingly concerned about the prospect of losing their most valuable holdings to SKM, scores of businesspeople began throwing their support behind opposition parties led by Viktor Yushchenko and Yuliya Tymoshenko. It was they who provided the bulk of the financing that allowed the Orange Revolution to take place. Although the Orange Revolution had many causes, the fear of Akhmetov likely provided a major impetus.¹⁵⁹

The revolution forced Akhmetov to flee Ukraine. However, shortly after taking power, Yushchenko, the new President, and Tymoshenko, his Prime Minister, had a falling out. After Yushchenko fired Tymoshenko in September 2005, the way was clear for Akhmetov to return to Ukraine. Upon his arrival, he met with investigators, answered some questions, and was immediately released. He would face no punishment whatsoever for any prior misdeeds.¹⁶⁰ For one thing, he could continue openly associating with known criminals. In 2007, he was seen at a soccer match in Israel in the company of Ruvim Aronov. Aronov was a Crimean organized crime boss whom police had already implicated in approximately 50 murders and eight kidnappings and who at the time was the target of an outstanding arrest warrant.¹⁶¹

For Akhmetov, the best of times were still to come. According to one estimate, by 2008 Akhmetov had displaced IKEA founder Ingvar Kamprad as the richest man in Europe. Perhaps atoning for the damage he had caused his country during his rise into this esteemed position, he established two of the most ironic charities of all time, the Foundation for Effective Governance and the Foundation for the Development of Ukraine. His contributions totaled less than one percent of his net worth. Given that his fortune itself allegedly stemmed from rendering Ukraine's government ineffective and its development stymied, perhaps he could have donated a bit more.¹⁶²

In an example of the feedback effects between soft budget constraints, the rise of political thugs, and raiding, the Yanukovich presidency brought further benefits to Akhmetov, principally in the sphere of privatization. DTEK, the energy arm of his business empire (formed out of the assets he obtained from the Klyuyev brothers), has now assumed a dominant position in electricity generation; by 2012 it controlled 33 percent of the country's generating capacity. DTEK was the sole bidder in privatizations that gave it blocking stakes in Ukraine's largest and third-largest power generation and distribution companies (Dniproenerho and Zakhidenerho, respectively). DTEK also won control of Kyivenerho and Donetskoblenerho at bargain prices and with little

¹⁵⁸ Andrei Lavrik, "Donetchane berut kontrol' nad Tsentral'nym GOKom," *Kontrakty* no. 44 (November 2003) – available at <http://archive.kontrakty.ua/gc/2003/44/61-donetchane-berut-kontrol-nad-centralnym-gokom.html?lang=ru>. Also see Andrei Lavrik, "God Voiny," *Kontrakty*, December 2003.

¹⁵⁹ Interview with Respondent #63

¹⁶⁰ Olga Dmitricheva, "Redecorated Cabinet," *Zerkalo Nedeli*, October 1-7, 2005

¹⁶¹ "Organized Crime Prosecutions Rarely Successful in Ukraine."

¹⁶² "Rich Rinat says to world: I'm No.1 in Europe," *Kyiv Post*, 9 July 2008.

competition. If that were not enough, it secured 70 percent of the available slots to export domestically-generated electricity.¹⁶³

Part of the reason for Akhmetov's continuing success under Yanukovich is that he has once again been able to place his cronies in key government posts. After the 2012 parliamentary election, Akhmetov "control[led] transportation, economy, social and regional policy in the government and [held] strong influence over Minister of Economic Development and Trade Ihor Prasolov, the former first deputy head of Akhmetov's business empire Systems Capital Management." Oleksandr Vilkul, an ally of Akhmetov who helped SKM expand into Dnipropetrovsk, was appointed Deputy Prime Minister along with Borys Kolesnikov, another Akhmetov man from Donetsk.¹⁶⁴

Akhmetov also helped to seal the fate of Taruta and Hayduk, his erstwhile business partners in ISD. Aside from competing with Akhmetov in the steel business, their political loyalties diverged from Akhmetov following the Orange Revolution; while Akhmetov supported Yanukovich's Party of Regions, his former partners switched their allegiances to the Orange Coalition, first supporting Yushchenko and later Tymoshenko. The problem for Hayduk and Taruta was that Akhmetov's SKM had a monopoly over the iron ore supplies that ISD needed to produce steel. This enabled Akhmetov to force ISD to purchase higher-cost iron ore from abroad. When the 2009 economic crisis struck, ISD found itself in trouble. Hayduk had to sell his stake in ISD to Russia's Vneshekonombank, and the latter now controls a majority of the company.¹⁶⁵

The widespread fear of Akhmetov among Ukraine's business elite persists to this day. According to one source, "companies often withdraw from tenders as soon as they find out that SKM is participating. They are well aware of the consequences that may fall upon them."¹⁶⁶

This is a tale that is all too common in the post-communist world. Thanks to personal ties with ex-communists who survived in power through the transition, an ambitious young thug manages to privately capture the flow of state subsidies and credits in the 1990s. He then leverages his growing wealth and connections into access to fraudulent privatizations. Having employed his considerable coercive resources to grow rich from soft budget constraints, he utilizes these same resources to become a criminal corporate raider.

Perhaps the only raiders who can match Akhmetov in terms of their reputation for aggressive takeovers are Ihor Kolomoisky, Hennady Bogolyubov, and Oleksy Martynov, owners of Pryvat. As with Akhmetov, one can see the same pattern by which soft budget constraints enabled their rise to wealth, particularly through one-sided transactions with state enterprises which they eventually privatized. The three partners had established Pryvat during the late Soviet period, when sought-after foreign goods were extremely scarce. Pryvat would acquire these goods and sell them at big markups. By the early 1990s, they had amassed enough capital to form Pryvatbank in Dnipropetrovsk to provide soft financing for their industrial activities. When Kuchma became Prime Minister in 1993 he actively supported the growth of their business. They in turn helped finance Kuchma's successful presidential bid in 1994.

¹⁶³ "Akhmetov's shopping spree," *Kyiv Post*, 26 January 2012.

¹⁶⁴ Kuzio, "Ukraine Sliding..."

¹⁶⁵ Matuszak, 29-30.

¹⁶⁶ Interview with Respondent #63

After Kuchma won, he rewarded Pryvat with control over the ferroalloy industry in Ukraine along with a number of manganese ore mining plants. Pryvat also secured appointments to manage a number of metallurgy plants. The enterprises remained state-owned, but managing was as good as owning. The plants would sell their output to Pryvat at low prices and Pryvat would subsequently export the ferroalloys at world market prices. All profits went to Pryvat while the costs were borne by the state enterprises. Pryvat formed similar arrangements in steel and pipes; in each case Pryvat would buy the finished products on the cheap and export them at a huge profit.¹⁶⁷ Later on, Pryvat gained formal ownership of many of these firms through rigged privatizations, most notably in the case of DneprAzot, a producer of mineral fertilizers (see privatization analysis above).

Initially, the main patron of Kolomoisky and his partners in Kyiv was Pavlo Lazarenko. Later, another of their business partners, fellow-plutocrat-to-be Serhiy Tihipko, entered government and promoted their interests.¹⁶⁸ They also maintained good relations with Kuchma through Viktor Medvedchuk when the latter served as Kuchma's chief of staff.¹⁶⁹ Such connections gave them access to the enormously lucrative soft budget constraints that launched these quintessential political thugs to the top.

Having become wealthy from the theft of state assets, Pryvat and the individuals around it would acquire notoriety for stealing private ones too. One of the raiding techniques they used to great effect was the illegal board meeting. All joint-stock companies in Ukraine are required to maintain a register that defines who owns how much of the company. Pryvat would simply create a second shareholders register that listed one of its representatives as a shareholder in the target firm. It would then file suit in a court in Crimea, Transcarpathia, or some other distant region where they had a friendly judge in their pocket. The judge would issue a favorable ruling confirming their proxy to be the rightful owner of the stake. Next, a board meeting would be held with all necessary attempts to bar rival shareholders from attending. A new management linked to Pryvat would be voted into place giving Pryvat full control. For good measure, they would often use state law-enforcement agencies or a private security team to escort the new management onto the company's premises.¹⁷⁰

In 2005, Pryvat attempted to raid the Nikopol Ferroalloy Plant.¹⁷¹ At the time, the factory was controlled by Viktor Pinchuk, the plutocrat who had privatized it in a highly questionable privatization two years earlier (see privatization analysis above). Unlike Pryvat, Pinchuk had backed the wrong side in the Orange Revolution; although Kolomoisky and his partners initially supported Kuchma's candidate, Yanukovych, they quickly switched sides and became allied with Tymoshenko. Now that Tymoshenko was Prime Minister, they seized their opportunity to act. Tymoshenko, allegedly acting on Pryvat's behalf, had the state nationalize Pinchuk's stake in Nikopol. The government then held a board meeting at which it appointed individuals close to Pryvat to senior posts in the company. However, Nikopol employees prevented the new management from

¹⁶⁷ Interview with Respondent #13

¹⁶⁸ "Ukrainian Oligarchs," *The Ukrainian Weekly*, 29 August 2011.

¹⁶⁹ Ihor Maskalevich, "The Inventory of Oligarchic Property: What's Next? ." *Zerkalo Nedeli*, August 23-29; "Weekly Looks at Russian Businessman's Prospects in Ukraine." *BBC Monitoring International Reports*, December 23, 2004.

¹⁷⁰ Interview with Respondent #13

¹⁷¹ PR #6

entering the premises of the plant. A series of lawsuits followed and revealed that the State Property Fund (FGI) lacked the legal right to assume ownership of the factory in the first place. All the same, it later emerged that Nikopol's bank accounts had already been transferred to Pryvatbank. The ouster of Tymoshenko and her government in September 2005 laid to rest any chance that Pryvat's raid would succeed. Eventually, Pinchuk's security team managed to put the old management back into place.¹⁷²

A similar takeover targeted a Polish-owned ice cream manufacturer.¹⁷³ After falling short of cash, the firm offered two companies a share in the statutory fund that owned the factory in exchange for a capital infusion. The two firms were KIB-Service, of Kharkiv, and Avagno Enterprises Limited, registered in Cyprus. While the promised money never materialized, the two new shareholders had enough documentation in their hands to initiate a raid. "The documents I signed effectively gave my former partners a chance to take over the factory," said Zbigniew Wróblewski, the plant's owner. Following a court decision the raiders sent in private security thugs to take control of the premises. Wróblewski thought he had emerged victorious when in 2006 the Supreme Court ruled that he indeed owned 100 percent of the factory. The General Prosecutor's Office launched a criminal case against the raiders to boot. But in August 2008 the High Economic Court in Kyiv ruled against him, giving the raiders control of the company. Wróblewski maintains that Pryvat was behind the takeover, claiming that the security company that took control of the factory was linked to Biola, a food company that lists Kolomoisky as an investor.¹⁷⁴

At times, corporate conflicts involving Pryvat could turn violent. In March 2007, Maksim Kurochkin, a "businessman" representing the Ukrainian interests of Russia's Luzhnikovskaya organized crime group, was murdered. The assassination occurred in the midst of a struggle with Pryvat over the Ozerka market.¹⁷⁵ Three of Kurochkin's business associates had been killed in the days prior to his own murder. Kurochkin himself was gunned down by a sniper as he was being escorted by police from a courthouse where he was standing trial for extortion.¹⁷⁶

In addition to the cases already mentioned, Pryvat's name has been associated with a huge number of criminal corporate raids, among which were Dneprofarm, Dnepropetrovsk House of Life, the Kyiv Technical Papers Factory, and the TV channel 1+1. Pryvat also benefited from a raid on a controlling stake in Ukratnafta, an oil refinery; successive court decisions in 2008 and 2009 invalidated previous purchases made by Russian interests in the company and the shares were subsequently acquired by Pryvat.¹⁷⁷ In the majority of these takeovers, Pryvat allegedly relied on the expertise of

¹⁷² "Neuchtennyi gosudarstvennyi interes," *Ekspert*, 24 April 2006 (<http://www.expert.ua/print/83/58/1905/>); Aleksandr Tomchenko, "NZF dostanetsya gruppe 'Privat'," *Kompromat.ru*, 6 July 2005 (http://www.kompromat.ru/page_17030.htm).

¹⁷³ PR #7

¹⁷⁴ "Foreign investors endure harassment;" interview with Respondent #130,

¹⁷⁵ Interview with Respondent #56; Interview with Respondent #63

¹⁷⁶ "Alleged gangster shot dead near Kyiv court." *Kyiv Post*, March 28, 2007.

¹⁷⁷ Matuszak, 31. Also see Tatneft, *OAO Tatneft Annual Report, 2010* (Almetyevsk, Tatarstan, Russia: Tatneft, 2010), 107.

Hennady Korban, the professional raider believed to be the architect of the attempted raid on the Ilyich Iron & Steel Works described earlier.¹⁷⁸

In early 2014, as crisis engulfed eastern Ukraine following the Euromaidan and the Russian invasion of Crimea, Kolomoisky – perish the thought – officially took charge of the henhouse when interim President Oleksandr Turchynov appointed him governor of Dnipropetrovsk.

Serhiy Tihipko, a one-time partner of Kolomoisky and his associates, is another political thug whose name has been linked to raiding. He began his career in the leadership of the Communist Youth League, which gave him connections to many of the key people in the emerging post-communist elite. Among these connections were future President Kuchma and future Prime Minister Yuliya Tymoshenko. In the early 1990s, the principals behind Pryvat hired him to form Pryvatbank to serve as a source of soft financing for the group. Having succeeded in this task, Tihipko was given a stake in the bank in 1995. In 2000 he sold out to Pryvat and used the proceeds to form own financial group, TAS. During the 1990s, Pryvatbank, under Tihipko's stewardship, purchased large amounts of state property. According to accusations levied by Hryhory Omelchenko, an MP and Ukraine's most prominent anti-corruption fighter, Tihipko's bank also facilitated a giant money laundering scheme from 1993 to 2001. In 1996, he was nearly arrested by the Interior Ministry for his role in this affair. But he was instead appointed Deputy Prime Minister in the infamous government of Pavlo Lazarenko. (Lazarenko would later claim that it was he who gave Tihipko "a way in life.")¹⁷⁹

Tihipko would go on to serve in a variety of prominent official roles. He became the head of the central bank at the same time that he retained his stake in TAS, which was a violation of the civil service law. Also in the 1990s, he allegedly assisted Lafarge, a company owned by the daughter of former French President Jacques Chirac, in its effort to gain control over a Ukrainian cement plant (Tihipko was later given a state award by the French President).¹⁸⁰

While at TAS Tihipko allegedly participated in a number of criminal corporate raids. One of these targeted the Kremenchug Steel Casting Plant, based in the region of Poltava.¹⁸¹ This was a dispute between its joint shareholders, plutocrat Leonid Yurushev, on the one hand, and Tihipko and Pryvat, on the other. On May 17th, 2006, approximately 200 gentlemen of athletic build stormed a general meeting of shareholders. In addition to brass knuckles, batons, and other pain-inducing instruments, the raiders came armed with documents giving them power of attorney to vote on behalf of representatives of Yurushev's Forum Bank. The thugs were eventually beaten back by members of a Berkut special forces unit and the meeting continued. Subsequently, numerous attempts were made by both sides to seize the plant by force. Each time, they came "armed with the decisions of various courts forbidding their opponents to hold meetings of shareholders and invalidating all orders by the opposing side." Akhmetov

¹⁷⁸ "Kto est' Kto: Privat, Ukraina," *Advisers.ru*, 15 May 2007

(http://www.advisers.ru/commerce_org/firm34.html). Accessed 8 August 2014.

¹⁷⁹ Vsevolod Bel'chenko & Valerii Kalnysh, "Bankir na vydanie," *Kommersant*, 25 January 2010 (<http://www.kommersant.ru/doc/1306214>); "Neudobnaya Pravda o Sergee Tigipko – 'novoi maske' v ukrainskoi politike," *Forum*, 21 December 2009 (<http://for-ua.com/press/2009/12/21/100621.html>).

¹⁸⁰ Ibid.

¹⁸¹ PR #8

eventually intervened in the conflict on Yurushev's behalf and the two warring factions reached a deal in 2008.¹⁸²

Yurushev, another plutocrat, began his business career in Donetsk in the late-Soviet period. There he had connections with organized crime boss and Akhmetov protégé Akhat Brahın as well as the circle around Viktor Yanukovych. After Brahın's death in 1995, he had to flee to Austria, where he spent the next several years. Earlier, in 1994, he established Forum Bank to support his trading and manufacturing activities. Ukrainian oligarchs frequently founded banks as an easy way of vacuuming up money from depositors that could then be used to finance their other businesses on soft terms. During the mid-1990s, Forum was linked to a massive money-laundering scheme to wash Pavlo Lazarenko's millions. Only in 1999, when new managers were brought in, did Forum begin to diversify its lending activities and become a more normal bank. This allowed Yurushev to eventually sell a controlling stake to Commerzbank in 2009 for \$600 million. Even by that point, the bank had a large portfolio of non-performing loans to Yurushev's various enterprises as well as other companies. Yurushev had to assume responsibility for these in order for the deal to go forward. Commerzbank eventually left Ukraine, reportedly because it could not deal with the corruption there.¹⁸³

Aside from banking, Yurushev is also heavily involved in the production and export of seafood. According to specialists, the business would not be profitable if not for the timely repayment of VAT by the state – a privilege hardly afforded to just anyone.¹⁸⁴ While Yurushev strongly resembles a political thug, I was not able to obtain enough information about his early career to definitively label him one.

Another plutocratic duo from Donetsk is Vasily Khmelnytsky and his longtime business partner, Andriy Ivanov. They rose to wealth in the same fashion as many of the previous plutocrats we considered; they first got themselves appointed to manage a state-owned enterprise and then privatized it at a ridiculous price. In the case Khmelnytsky and Ivanov, it was the Zaporizhstal steel mill, one of Ukraine's largest steel manufacturers, that would propel them to wealth and prominence.¹⁸⁵ Having managed it through much of the 1990s, they later won control of the factory in a fraudulent privatization in 2001 (see privatization analysis above). They also gained access to the privatizations of various energy assets, including Kyivoblenerho and Kyivhaz, thanks in part, allegedly, to the lobbying efforts of Ivanov.¹⁸⁶ After moving out of the steel business, they reportedly became involved in illegal schemes to acquire land.¹⁸⁷ The two partners were supporters of Tymoshenko in the run-up to the Orange Revolution. Khmelnytsky was elected to

¹⁸² "Konspiratsiya Leonida Yurusheva. Chast' 1," *Yustus Information Portal*, 20 November 2007 (<http://justus.com.ua/ua/inter/2007/11/20/564/>); "Konspiratsiya Leonida Yurusheva. Chast' 2," *Yustus Information Portal*, 24 November 2007 (<http://justus.com.ua/ua/inter/2007/11/24/573/>).

¹⁸³ "Konspiratsiya Leonida Yurusheva. Chast' 1," "Skromnoe obayanie' bankira Yurusheva," *Oligarh.net*, 24 May 2005 (<http://oligarh.net/?/actually/12292/>); Oleksiy Komaha & Serhiy Lyamets', "Yaroslav Kolesnyk: Vsyia presa kazhe pro mene 'bankir Yurusheva'," *Ekonomichna Pravda*, 26 April 2012 (<http://www.epravda.com.ua/publications/2012/04/26/322352/>).

¹⁸⁴ Mustafa Haiem, "Arsenii Yatseniuk: istochniki finansirovaniya," *Ukrainskaya Pravda*, 21 July 2009 (<http://www.pravda.com.ua/articles/2009/07/21/4106841/>).

¹⁸⁵ "The 30 Richest Ukrainians."

¹⁸⁶ Bogdan Salenko, "Karmannyi oligarkh Timoshenko," *Chetverta vlada*, 15 November 2005 (accessed at <http://4vlada.net/partii-lidery/karmannyi-oligarkh-timoshenko/>).

¹⁸⁷ Interview with Respondent #63

parliament in 2006 while Ivanov served in the Kyiv city council, both as members of Tymoshenko's political party.¹⁸⁸

Like Khmelnsky and Ivanov, two other political thugs, Eduard Shifrin and Oleksandr Shnaider, also became rich through soft budget constraints from Zaporizhstal. In 1994, the two teamed up to form Midland Resources, registered offshore in the British Crown Dependency of Guernsey. (Practically all of Ukraine's plutocrats, along with those of the other three countries, base most of their business holdings in offshore tax and secrecy havens.) Midland made a fortune tunneling the assets of Zaporizhstal alongside and in frequent competition with Ivanov and Khmelnsky. Before the company was slated for privatization, Khmelnsky won an appointment to manage the state's shareholding and began buying up shares when the auctions began. At this point, Shifrin and Shnaider realized they needed to participate in the privatization lest they lose their livelihood; "[i]f we didn't buy the steel mill our business would be finished because nobody was going to let us keep making [those] absurd margins," admitted Shnaider in a remarkably frank moment. In the end, the two rival teams managed to shelve their differences and privatize Zaporizhstal together in an obscenely fraudulent transaction (see above).¹⁸⁹

Viktor Pinchuk is one of Ukraine's richest political thugs, although he has not been linked to raiding. Like so many others, he made his fortune in the lucrative gas trade in the 1990s. He founded Interpipe, a producer of metal pipes. Its success was aided by his onetime father-in-law, a prominent official in Dnipropetrovsk. Interpipe sold pipes in exchange for gas, most prominently to the regime of Islam Karimov in Uzbekistan. During the early 1990s, as Lazarenko began consolidating control over Dnipropetrovsk through his massive, province-wide extortion scheme, Interpipe started receiving unwanted attention. It staved off the threat, at least for a while, by partnering with Lazarenko's protégé, Yuliya Tymoshenko, in a 50/50 joint venture called Sodruzhestvo. Sodruzhestvo did exactly the same thing as Interpipe – it sold pipes in exchange for Central Asian gas – except that half the proceeds went to Lazarenko and his cronies. It did not take long before Tymoshenko struck out on her own and raided Pinchuk's portion of the business. At one point during the takeover, Pinchuk was kidnapped. He was saved only after Serhiy Tihipko put up the \$2m ransom to secure his release. To this day, Pinchuk maintains that he does not know who was behind the kidnapping. Nevertheless, while he was in captivity officials struck Interpipe from the list of authorized gas dealers in Dnipropetrovsk.¹⁹⁰

Following this incident, Pinchuk formed an alliance with Itera to import Central Asian gas. After Lazarenko's fall, the way was clear for Pinchuk to return to the fold. Having divorced his first wife, he began courting Kuchma's daughter, whom he eventually married in 2002. Not coincidentally, perhaps, Interpipe began winning lots of lucrative privatizations. Most notable among these was the Nikopol Ferroalloys Plant, bought for a paltry \$80 million, and the notorious privatization of Kryvorizhstal.¹⁹¹

¹⁸⁸ "The 30 Richest Ukrainians."

¹⁸⁹ Heidi Brown and Nathan Vardi, "Man of Steel," *Forbes*, 28 March 2005 (<http://www.forbes.com/forbes/2005/0328/132.html>).

¹⁹⁰ Vladimir Fedorin & Lesya Voititskaya, "Zima oligarkha," *Forbes Ukraina*, March 2011 (<http://forbes.ua/magazine/forbes/1332420-zima-oligarha>).

¹⁹¹ *Ibid.*

Vadim Novinsky, also a member of the plutocratic elite, can most certainly be described as a political thug. He came to Ukraine from Russia in the 1990s and eventually became a naturalized citizen. In February 2000, his Smart Group received a major windfall when it was granted the right to manage the state's stake in the Inhulets Ore Mining & Processing Works (InGOK). According to at least one report, it systematically siphoned assets from the plant and used part of the proceeds to eventually purchase it. By July 2004, Smart Group had privatized the state's entire remaining stake, buying the last portion, a 37.57 percent share, for a mere \$31 million. Novinsky also runs agricultural operations but only in regions such as Kyiv and Mykolayiv where he maintains good relations with the authorities.¹⁹²

Novinsky has been associated with raiding, particularly in the case of the Chernomorsky Shipbuilding Plant (ChSZ).¹⁹³ Beginning in 2005, the State Property Fund began making accusations against its main owner, Ihor Churkin, regarding the way he privatized the plant in 2000. It also filed a series of lawsuits against him. Given that the Fund was claiming malfeasance in the conduct of the initial privatization, one would expect that it ultimately intended to take control of ChSZ and subsequently reprivatize it in a more legitimate manner. After all, just to be sure that Churkin would not be able to sell his stake pending the outcome of the lawsuits, authorities froze his shares. Then, in December 2007, Churkin was arrested and detained by the Interior Ministry on charges relating to the ChSZ privatization. However, the very next day an announcement appeared claiming that Churkin had sold his 90 percent shareholding in ChSZ to firms linked to Novinsky. That same week, the State Property Fund did an about-turn on its previous stance and gave its stamp of approval to the sale. This was despite the active freeze on Churkin's shares that had previously been ordered by the Fund itself. Suddenly, the same state body that had questioned the legitimacy of ChSZ's privatization to Churkin now recognized his right to sell the plant to structures connected to Novinsky. The Anti-Monopoly Committee also approved the sale. The only one who seemingly did not was Churkin himself; according to his lawyers, the reputed sale of his shares was completely fictitious and its official notarization thus constituted a criminal act.¹⁹⁴

Kostyantyn Zhevago is another member of the plutocratic elite whose name has surfaced in connection to raiding. Greatly facilitating his start in business was his friendship with the son of Valery Cherp, who served as Transport Minister and director of UkrAgroStoy during the 1990s. Thanks in part to this connection, Zhevago was appointed as financial director of the Kyiv-based Finance & Credit Bank at the tender age of 19. By forging relationships with other key businessmen at the time, including Viktor Medvedchuk, Hryhory Surkis, and Ihor Bakay, he was able to enter the ranks of Ukraine's business elite.¹⁹⁵ In particular, he and his friends made a fortune as intermediaries in the sale of gas from Turkmenistan to Ukrainian consumers. But their biggest break came in 1996 when they won the privatization of the Poltava Ore Mining &

¹⁹² "Vadim Novinskii," *KompromatUA*, 3 December 2007 (<http://kompromat.ua/ru/16/608/>). Accessed 8 August 2014; "Oligarkh Vadim Novinskii. Osobennosti biografii," *SLED.net.ua*, 14 May 2013 (<http://sled.net.ua/oligarkh/novinskiy/osobennosti/biografii/2013/14/05>). Accessed 8 August 2014.

¹⁹³ PR #9

¹⁹⁴ Evgenii Kritskii, "Ekonomika dlia 'zakazov'?" *ZN,UA*, 21 December 2007 (http://gazeta.zn.ua/ECONOMICS/ekonomika_dlya_zakazov.html).

¹⁹⁵ "Nine billionaires among Ukraine's 30 richest men," *The Ukrainian Weekly*, 9 July 2006.

Processing Works, Ukraine's largest iron ore exporter.¹⁹⁶ Later on, Finance & Credit won stakes in a number of regional energy distributors, proceeding to siphon off their assets by paying trivial amounts for electricity and then selling it at a substantial profit.¹⁹⁷

Zhevago's name first became known to the public in 2001 when a little-known company called Avtokraz, owned by Oleksy Kucherenko, the then-governor of Zaporizhzhya and Zhevago's business partner, won the privatization tender for the Zaporizhzhya Aluminum Plant. However, Avtokraz was unable to put up enough cash to guarantee payment and so the sale was awarded to another company owned by Russian oligarch Boris Berezovsky. A series of court cases followed in addition to an incursion by a private security team to seize the plant by force. The raid failed as somebody at the plant had been tipped off beforehand, enabling police to arrive early on the scene to protect the incumbent management.¹⁹⁸

Another political thug, Borys Kolesnikov, made his fortune as a close associate of Rinat Akhmetov in Donetsk, with whom he has maintained a friendship since the 1980s when the two men were in their twenties. "According to unofficial biographical data, Kolesnikov's close ties with the underworld appeared from the moment he took leadership of the trading firm, Yug." Kolesnikov's business interests have benefited from a series of fortuitous deaths. Among these was his former partner Serhiy Roman, whose murder enabled Kolesnikov to take control of the Kyiv-Conti confectionary, and Yury Pavlenko, whose Sarmat Brewery passed into the hands of Akhmetov following Pavlenko's death. In Spring 2005, in the wake of the Orange Revolution, Kolesnikov was arrested on charges of extortion against the shareholders of the White Swan shopping center.¹⁹⁹ Its previous owners, Borys Penchuk and his family, were forced to sell out to Kolesnikov and others after receiving repeated threats; former Interior Minister Lutsenko reported that there were multiple attempts on Penchuk's life. In July 2005, the Prosecutor General's Office closed the case due to "lack of evidence." But it did find enough evidence to prosecute Penchuk – the alleged victim – for extortion and making false accusations.²⁰⁰

In another example of feedback effects, Kolesnikov used his growing wealth from soft budgets and raiding to gain access to further soft budget constraints later on. When Ukraine was chosen to host the 2012 European soccer championship, it was clear that the government would have to hold numerous public tenders for infrastructure improvements, stadium construction, and the like. At the time, a new law required that any government contract exceeding a cost of UAH 100,000 be awarded through a competitive tender. However, the pro-presidential Party of Regions, a political vehicle for Donetsk businessmen like Kolesnikov, engineered the passage of a provision that allowed contracts for the soccer championship to be granted through "tenders with one participant." Under this exception, all such tenders would be decided by a special agency

¹⁹⁶ "Milliardy iz khaosa," *Forbes Ukraina*, 9 November 2011.

¹⁹⁷ Ihor Maskalevich, "Ukrainian specifics of energy privatization: the third 'coffee break'." *Zerkalo Nedeli*, August 4-10, 2001

¹⁹⁸ PR #10. Interview with Respondent #13.

¹⁹⁹ PR #11

²⁰⁰ Sergei Rudenko, "Kolesnikov Boris. DOS'E," Rudenko.kiev.ua, accessed 30 June 2014 (<http://www.rudenko.kiev.ua/persons/kolesnikov>); "Novost': Belyi vorotnikov," *Porojniak.net*, 13 April 2006, accessed 8 August 2014 (<http://porojniak.net/print.php?news.753>); excerpt from Serhiy Kuzin, *Donetskaya Mafiya: Antologiya* (<http://www.litmir.net/br/?b=201685>), accessed 8 August 2014

headed by Kolesnikov himself. He duly proceeded to dole out lucrative public contracts without any competition to companies that he and his allies controlled. Among these were the commissioning of a firm called Altcom to build roads, an airport, and a stadium in Lvov in western Ukraine even though the contractor was based 1000 kilometers away in the eastern part of the country; a huge contract to build a stadium in Kyiv awarded to a tiny company linked to Kolesnikov; and the purchase by the city of Kharkiv of new benches for the city's metro stations at 2000 euros apiece.²⁰¹ Like Oleksandr Volkov, Kolesnikov too has also been recognized for his contributions "For Service" to Ukraine. In fact, it was President Yushchenko, whose General Prosecutor had only shortly before charged Kolesnikov with extortion, who bestowed the award upon him.²⁰²

Also a political thug is Yevhen Chernyak, owner of Khortytsa, whose prime asset is beverage-maker Global Spirits. In the 1990s, he operated metallurgical waste dumps in Zaporizhzhya alongside a local organized crime gang. Using the proceeds from this operation in addition to financing from a local bank secured by his father's connections, he later formed Khortytsa and Global Sprits. Despite numerous laudatory articles in the press, industry experts and former employees maintain that his beverage operation "survives thanks to refinancing and manipulation on the black market for alcohol... The holding can be destroyed in the blink of an eye: it would merely require creditor banks to collect on its debts or to bring to a logical conclusion the collection of almost a billion hryvnias (or, rather, 907,193,600) in unpaid taxes which Chernyak still manages to 'tie up' in the courts." He has also maintained his associations with organized crime elements in Zaporizhzhya, namely Arashes "Artash" Sargsyan. With the help of local and national law-enforcement, the two allegedly partnered in a scheme to collect compromising information on local business owners that could be used to extort money from them. More recently, Chernyak has formed a political association, "Patriots of Zaporizhzhya," to represent the interests of Zaporizhzhya businessmen, helping them "defend the positions of their dubious businesses, often based on monopolies or raiding," according to one report. Various articles allude to alleged criminal corporate raids in which Chernyak has played a part. But I could not find sufficient details on any specific case to label him a raider.²⁰³

Volodymyr Boyko is a typical red director who made his career in the Ilyich Iron & Steel Works (MMK) in Donetsk. He was appointed its head in 1990 due to his good relationship with the powerful Soviet Deputy Minister of Ferrous Metals, Rudolf Guniak. Thereafter he was able to parlay his solid connections into further success,

²⁰¹ Interview with respondent #133; Luke Harding and David Leigh, "Euro 2012: Uefa urged to investigate \$4bn corruption allegations in Ukraine," *The Guardian*, 20 June 2012 (<http://www.theguardian.com/football/2012/jun/20/euro-2012-corruption-allegations-ukraine>).

²⁰² "Organized Crime Prosecutions Rarely Successful in Ukraine."

²⁰³ "Zaporozhskii rasklad: 'Anisim' vzyat, no rano radovat'sya Chernyaku," *ORD*, 23 October 2013 (originally appeared in *Argument*, 22 October 2013). Accessed 8 August 2014 at <http://ord-ua.com/2013/10/23/zaporozhskij-rasklad-anisim-vzyat-no-rano-radovatsya-chernyaku/?lpage=1>. "Evgenii Chernyak: Anotomiya predatel'stva v terrariume," *Censor.net*, 12 September 2013, accessed 8 August 2014 (http://censor.net.ua/forum/667804/evgeniyi_chernyak_anotomiya_predatelstva_v_terrariume); Anatolii Zakhov, "Kak Evgenii Chernyak pytaet'sya stat' pervym parnem' v gorode," *Ob'ektiv*, 24 August 2013 (<http://www.objectiv.tv/forum/viewtopic.php?f=6&t=11225>); "Khortytsa' na krovi. Chast' 1. Kak Evgenii Chernyak stal vodochnym baronom," *Advocat-konsalting*, accessed 30 June 2014 (http://advocat-cons.info/index.php?newsid=18245#_U5MG8nJ_u6A); "Evgenii Chernyak xhozyain goroda," *Advocat-konsalting*, accessed 30 June 2014 (<http://advocat-cons.info/index.php?newsid=18277>).

particularly when another powerful official, Anatoly Holubchenko, agreed to lease MMK to its workers' collective in the early 1990s, which Boyko effectively controlled. He maintained links to President Kuchma throughout the latter's term in office. In 2000, a former employee at MMK, then serving as a parliamentary MP, submitted a bill to privatize 51 percent of the company to the workers' collective. The sale was approved; a company with a \$133 million profit in 2000 alone was sold for a mere \$83.5 million. Boyko himself formally owned only one percent of the plant but was able to effectively control it thanks to its confusing ownership structure. As mentioned earlier, he was eventually forced to cede control to Akhmetov in order to fend off an attempted raid orchestrated by Hennady Korban.²⁰⁴

Volodymyr Matviyenko, the longtime boss of Prominvestbank (PIB), is another political thug. Prominvestbank was split off from the Soviet-era Promstroybank after Ukraine gained independence. It, along with the other two Promstroybank successors (Agroprombank and Ukrsootsbank) enjoyed massive state subsidies through the mid-1990s. These gave them huge advantages over other banks. They were nevertheless obliged to continue lending to insolvent state enterprises and would often never see the money again. Eventually, Matviyenko gained a controlling stake in the bank through a privatization. But he was later forced to cede control to a consortium of the Klyuyev brothers and Russia's Vneshekonombank during the 2009 financial crisis (see above).²⁰⁵

Aside from being a crucial transit country through which a full quarter of Russian and Turkmen gas moves to European customers, Ukraine is itself a major customer for the gas due to its enormously inefficient industrial base. Thus, it was not exactly a stunning revelation when in 1998 Ihor Bakay publicly announced that "all the richest people in Ukraine made their money from Russian gas."²⁰⁶ Having made his own fortune in the lucrative gas trade, in both a private and official capacity, he is one to know.

Perhaps the most blatant example (of many blatant examples) in which a new gas billionaire emerged out of nowhere thanks to soft budget constraints is Dmytro Firtash. Firtash is a political thug of the first order. Virtually nobody had heard of him before 2006 when Austria's Raiffeisen Bank suddenly announced that it was acting as manager of a 50 percent stake in RosUkrEnergo on behalf of Firtash and another businessman, Ivan Fursin. Having no real assets or prior experience in the gas trade, RosUkrEnergo had been set up two years earlier as a completely unnecessary intermediary in the supply of gas from Turkmenistan through Russia and into Ukraine. RosUkrEnergo would buy the gas cheaply from Gazprom, Russia's gas monopoly, and sell it at a huge markup to Naftohaz Ukrainy, Ukraine's state gas monopoly. In the process it siphoned off billions of dollars from the Ukrainian state. Fursin, owner of five percent of RUE, was a shareholder only in name. He was allegedly the front man for stakes held by President Kuchma and Serhiy Lyovochkin (then a senior advisor to Kuchma and now chief of staff to President Yanukovich).²⁰⁷

²⁰⁴ Musaeva & Aksyonov, "Pensionnyi kapital."

²⁰⁵ Davidenko, "Ruka Moskvu."

²⁰⁶ "Ukraine's Oligarchs Emerge from Soviet System." *Kyiv Post*, April 4, 2002.

²⁰⁷ "Gas, corruption, and non-transparency." *Kyiv Post*, 10 May 2006; Taras Kuzio, "Dmytro Firtash Launches New Opaque Gas Intermediary," *Eurasia Daily Monitor*, 25 March 2013 (http://www.jamestown.org/single/?tx_ttnews%5Btt_news%5D=40641).

Of the 50 percent of RUE that Raiffeisen managed on behalf of the Ukrainian investors, Firtash held the other 45 percent. Immediately, however, allegations began to mount that Firtash too was a front man, in his case for international criminal mastermind Semyon Mogilevich (long a fixture on the FBI's Ten Most Wanted Fugitives list). While Firtash has always publicly denied holding the stake for Mogilevich, he is quoted in Wikileaks as admitting to close ties with the mobster.²⁰⁸ The other 50 percent of RUE was owned by Gazprom.

The history of this arrangement stretches back to the mid-1990s when there were a number of private gas traders operating in Ukraine. Among these were YESU (tied to Tymoshenko and Lazarenko) and ISD, both discussed earlier. In 1994 a Russian company called Itera established itself as another intermediary. It purchased gas from Turkmenistan, transported it through Gazprom's own pipelines, and sold it at a substantial profit to Gazprom and Naftohaz, taking business away from both in the process. Nobody from Gazprom was ever able to provide a convincing explanation as to why Itera was allowed to do this. This prompted many to speculate that Itera was simply a vehicle used by Gazprom's upper management (and myriad other power holders within and beyond the Russian government) to siphon off assets from the Russian gas monopoly. Nor could anybody credibly explain what benefits it brought to either Naftohaz or the people of Ukraine, given that neither Naftohaz nor the Ukrainian state had a stake in the intermediary.²⁰⁹

After he was elected President in 2000, Putin vowed to end this shady state of affairs. Ultimately he did no such thing; he simply arranged with the management of Naftohaz to replace Itera with another intermediary, Eural Tranz Gaz (ETG). Registered in Hungary, ETG had not even existed until a month before it won the contract. When it assumed responsibility for the gargantuan gas trade between Turkmenistan, Russia, and Ukraine, the company had only 30 employees and \$12,000 in capital. Its managing director apparently had no prior experience in the gas business (he previously sold cigarettes). Asked what the purpose was of registering the firm in Hungary, a representative of ETG noted that tax rates there were much lower than in Russia. The Russian government presumably thought it a good idea to forego these hundreds of millions of dollars in tax revenues that would otherwise have filled its own coffers.²¹⁰

It was not long before ETG too became mired in controversy, potentially creating a major scandal for the governments of Ukraine and Russia. Not to worry; in July 2004 they simply cancelled the contract with ETG and replaced it with RosUkrEnergo. This was another useless intermediary which continued to profit from the massive siphoning of assets from Gazprom and Naftohaz Ukrainy. Until Raiffeisen came out and actually revealed the names of the Ukrainian shareholders in RUE, Gazprom continued to maintain the ruse that it simply did not know who its Ukrainian partners were. In another inexplicable twist (inexplicable, unless you assume the corrupt collusion of Naftohaz managers in the tunneling of their own company), it emerged that Yury Boyko and Ihor Voronin, two senior officials at Naftohaz, sat on RUE's coordinating committee. This was odd given that state-owned Naftohaz had no stake whatsoever in RUE and that the

²⁰⁸ Leshchenko, "In Ukraine, it grows on trees..." *ODRussia*, 20 August 2013.

²⁰⁹ Global Witness, *It's a Gas: Funny Business in the Turkmen-Ukraine Gas Trade*.

²¹⁰ *Ibid.*

two “public servants” had been nominated to the committee at the behest of Firtash, one of RUE’s main owners.²¹¹

During most of this period, Ihor Bakay held prominent posts at Naftohaz. After the Orange Revolution, the Security Service of Ukraine (SBU) launched an investigation into RUE. An arrest warrant was issued for Bakay, who had already fled to Russia. As the investigation heated up in the fall of 2005, Yushchenko dismissed Tymoshenko, his Prime Minister, and Oleksandr Turchynov, the SBU’s head. This move not only ended the investigation; after this point Ukrainian officials suddenly began to deny that this very public investigation had ever taken place at all.²¹² Many of the old guard from Naftohaz were now brought back into the fold, including Bakay. Not only that, in January 2006 a crisis over the price of gas that Ukraine was to pay to Gazprom led the Russians to reduce the gas supply to Ukraine, leaving millions of West European consumers freezing. The crisis was resolved after the two countries struck a deal that gave an even stronger market position to RUE. Nevertheless, after returning to power, Tymoshenko concluded a new deal with Moscow in 2009 that ended RUE’s privileged position in the gas market. Around the same time, Mogilevich was arrested in Russia. Prior to that he had lived there for years, freely and out in the open despite his place on the FBI’s list. He was released a short while later on the grounds that the alleged crimes he committed were “not of a particularly grave nature.”²¹³

The political thugs who had grown so wealthy siphoning Naftohaz’s assets through soft budget constraints were down but not out. The return of Yanukovich to power in 2010 brought the good times back for the “gas lobby,” of which Firtash is one of the most prominent representatives. Firtash was additionally able to privatize a number of big chemical producers and increase his control over the mineral fertilizer industry. In 2012 the Azarov government authorized his DF Group to privatize at reduced prices stakes in 12 regional gas distributors (*oblenerhos*). Most notably, his new company, OstChem Gas Trading (registered in Switzerland just as RUE had been) became the new intermediary in the supply of Russian and Turkmen gas to Ukraine.²¹⁴

Has Firtash been involved in criminal corporate raiding? Rumors arose around 2006 and 2007 regarding the circumstances in which a number of private businessmen suddenly began selling their stakes in *oblenerhos* to structures linked to Firtash. Various suggestions have appeared in the media suggesting that many of these sales were not exactly voluntary.²¹⁵ However, I was unable to find enough information on these takeovers to suggest that they constituted raids.

Oleksandr Yaroslavsky also holds a place on the list. A former a police inspector, he rocketed to the top of Ukraine’s business elite first by marrying the daughter of the governor of Kharkiv and then by cultivating ties to Kuchma. Like so many other wealthy Ukrainians, he made his initial fortune selling Russian gas, in his case to customers in gas-starved Kharkiv. In 1999-2000 he was reported to have acquired a stake in the Pivnichny Ore Mining & Processing Plant, one of a handful of lucrative ore mining

²¹¹ Ibid.

²¹² Ibid., 6.

²¹³ “Russia frees crime boss wanted by U.S.,” *Reuters*, 27 July 2009.

²¹⁴ “Dmytro Firtash Launches New Opaque Gas Intermediary,” *Eurasia Daily Monitor*, 25 March 2013.

²¹⁵ Daria Isakova, “Biznes Vkrutuiu,” *Forbes Ukraina*, 22 May 2012; Daria Isakova, “Biznes Vkrutuiu,” *Forbes Ukraina*, 22 May 2012; Igor Maskalevich, “Oblgazy.(Anti)Monopoliya,” *ZN,UA*, 19 October 2012.

enterprises in the country (others are variously controlled by Akhmetov, Zhevago, and Novinsky).²¹⁶ He also won the privatization of the Severny Ore Mining & Processing Plant in a rigged tender after offering little more than the asking price.²¹⁷ He and his business partner acquired Ukrsibbank as well and in late 2005 sold half their stake to France's BNP Paribas.²¹⁸ More recently he benefited from lucrative state contracts to build facilities for the 2012 European soccer championship.²¹⁹ The question of his involvement in raiding remains somewhat unclear. That being said, he did end up with a 25 percent stake in Ukrtatnafta following a 2008-09 raid on the company by Pryvat.²²⁰

Vasily Gorbali is another political thug who made it rich from the gas business, although in his case by financing it. In the mid-1990s, when Ihor Bakay was busy siphoning assets in the gas trade, he needed a bank to service his operations. To this end he established Interhazbank in 1996 and appointed the young Gorbali, who had received financial training in Germany, to run it. In 1997, they would rename the bank Ukrhazbank. That year, Bakay was appointed Minister of Oil and Gas. Ukrhazbank began servicing the various gas trading companies around Bakay including Interhaz, UKRHAZ, and others. In 1998, when the Kuchma administration decided to consolidate the domestic gas distribution industry by forming Naftohaz Ukrainy, Bakay was appointed to head the new state monopoly. He naturally chose his own Ukrhazbank to handle its financing needs. Over time, however, Bakay gradually – and then completely – ceded his stake to Gorbali, first to satisfy debts to Ukrhazbank and eventually when he found himself on the political ropes in 2000 thanks to a conflict with Gazprom and Yuliya Tymoshenko. At that point, Kuchma accused the bank of siphoning funds from Naftohaz that were intended for Turkmenistan. Later, in 2002, the Prosecutor-General's Office, acting on a tip from Hryhory Omelchenko, Ukraine's most prominent official corruption-fighter, began investigating Bakay and Gorbali for allegedly using Ukrhazbank to steal money from Naftohaz. The bank suffered another setback after Bakay's fall from grace when his successor turned to another financial institution for Naftohaz's financial needs. But Gorbali, with direction from Bakay, continued growing the bank's business, in part by securing agreements to service a variety of state organs from the Ministry of Internal Affairs to the Ministry of Health, the Presidential Administration, and the SBU. Gorbali's efforts to ink these deals may have been aided by the fact that he won election to parliament and gained a seat on the Finance and Banking Committee.²²¹

If gas has become a major focal point for Ukraine's political thugs, so has electricity, which has proven a similarly lucrative source of soft budget constraints. As with the gas industry, the main mechanisms involved were input-output schemes, tax breaks, the allocation on political grounds of special state quotas, and corrupt privatizations. The sector later became the object of a series of criminal corporate raids perpetrated by the beneficiaries of these soft budget constraints. In particular, it was the battleground for one of the country's epic business conflicts, pitting Konstantyn Hryhoryshyn against fellow plutocrat Hryhory Surkis. Hryhoryshyn is a Russian

²¹⁶ "The 30 Richest Ukrainians."

²¹⁷ Maskalevich, "The Inventory of Oligarchic Property..."

²¹⁸ "The 30 Richest Ukrainians."

²¹⁹ "Ukraine: Big Tycoons Getting Bigger," *Transitions Online*, 20 June 2008.

²²⁰ Interview with Respondent #131.

²²¹ Natal'ya Guzenko, "Spetsproekt 'Neizvestnaya Ukraina': Bankir Fortuny," *Kontrakty No. 27*, July 2007 (<http://archive.kontrakty.ua/gc/2007/27/14-vvp-demokratii.html>).

businessman who came to Ukraine in the 1990s to exploit its untapped sources of wealth. Skilled at making friends and gaining people's trust, he was soon able to establish control over a number of state enterprises, one of which was engaged in nuclear fuel processing. He could only secure this appointment with a wink and a nod from regulators who otherwise would have prevented foreign influence in such a strategic sector. Hryhoryshyn also gained control of steelmaker Dniprospsstal, allegedly with the help of Pavlo Lazarenko, his onetime business partner. Dniprospsstal would become Hryhoryshyn's most valuable asset.²²²

Many of the factories he came to control were energy-intensive, dependent on the supply of electricity from the *oblenerhos*, the state-owned energy distribution companies. Whoever controlled the *oblenerhos* would be able to force their way into other firms in Ukraine's energy-intensive sectors. As the *oblenerhos* came up for a first round of privatization in 1997, they became the scene of some of the most vicious and internecine business battles in the history of post-communist Ukraine.

Hryhoryshyn initially enjoyed the protection of Ihor Kolomoisky and Pryvat. However, the far more powerful Pryvat eventually muscled him out of a number of his enterprises. Around the same time, Surkis, along with Viktor Medvedchuk and other associates, were looking for partners in the *oblenerho* privatizations. Surkis and Medvedchuk were beneficiaries of the elite-led nature of Ukraine's transition; both had ties to the communist party-state apparatus and were thus in prime position to exploit new business opportunities under the patronage of their ex-communist colleagues. Surkis had acquired his initial fortune in the early 1990s thanks in large part to his patron, Valentyn Zhursky, then-mayor of Kyiv (he later joined Surkis as a business partner). Surkis and Medvedchuk also managed an investment pyramid scheme called Ometa-21st Century, which in 1996 left its owners holding shares worth 2.4 kopeks apiece after peaking at 1350 in 1993. They also formed Slavutych, which made huge profits importing oil from Russia and Kazakhstan. The secret to their success, according to Bohdan Hubsy, one of their partners, was buying oil "from those with whom we have long-established working ties."²²³ These ties enabled Slavutych to win the right to import oil VAT-free, depriving the national budget of UAH 3 billion as a result. By 1998 Slavutych was supplying oil to over 2000 industrial clients. Aside from oil, in 1994 it received lucrative quotas to import Turkmen gas at the expense of the state, whose gas debts to Turkmenistan increased by \$243 million in that year alone. Another joint venture imported enormous quantities of alcohol and tobacco, duty-free.²²⁴

Those "long-established working ties" additionally paid off with Leonid Kravchuk, Ukraine's first President, and Kuchma, his successor. Kuchma even awarded Surkis and Medvedchuk with the "Order For Service to Ukraine," that prestigious state honor which counts so many notorious political thugs among its past recipients. In the late 1990s, the two partners founded the Social Democratic Party of Ukraine-united, or SDPU(o) for short, to represent their interests in the national legislature. The party

²²² "Weekly Looks at Russian businessman's prospects..."

²²³ Serhiy Rakhmanin and Yulia Mostovaya, "Ukrainian political parties, part VI: the social democratic party (united)." *Zerkalo Nedeli*, March 16-22, 2002

²²⁴ "Ukrainian Oligarchs," *Kyiv Post*, 29 August 2011.

succeeded in entering parliament in the 1998 elections after it “hardly managed to crawl over the four percent barrier.”²²⁵

At the time they entered the electricity-distribution business, however, Surkis and Medvedchuk were not necessarily acting on their own. They did not yet enjoy the kind of wealth that would have allowed them to play in the same league as Ukraine’s ultra-wealthy oligarchs. What they did have to offer potential partners was their formidable administrative resources. In the battle for the *oblenerhos*, in particular, they had another partner in addition to Hryhoryshyn. That partner was Russia’s infamous Luzhnikovskaya organized crime group, represented in Ukraine by Maksim Kurochkin (the one who would later be assassinated on the courthouse steps in 2007). Well before becoming involved in Ukrainian energy distribution, the Luzhnikovskaya organization had begun to move away from simple extortion and into legal businesses.²²⁶

Hryhoryshyn, for his part, was sorely lacking in political protection after the ouster of Lazarenko and his abandonment by Kolomoisky. But he could now count on his new partners, Surkis and Medvedchuk, for any necessary political cover. Medvedchuk held a number of prominent positions in the Kuchma’s administration,²²⁷ one of which, ironically, was a seat on the President’s Coordination Committee for Fighting Organized Crime and Corruption.²²⁸ If Surkis and Medvedchuk offered Hryhoryshyn political cover, Hryhoryshyn provided a cover for their business interests, holding shares on their behalf so they could claim plausible deniability (given Medvedchuk’s official role in the Presidential Administration).²²⁹ Of the first seven *oblenerhos* that were privatized, the investment pool of Hryhoryshyn, Surkis, and Medvedchuk was able to acquire five.²³⁰

Soon, however, the partners fell out as each side began to eye exclusive control of the *oblenerhos*. Hryhoryshyn became the first victim in this battle. Refusing to support the SDPU(o) in the 2002 parliamentary elections, Hryhoryshyn instead backed another party that did not make it into parliament. Left without political protection once again, he was now exposed, and Surkis and Medvedchuk decided to pounce. In 2002 he was arrested and briefly jailed by the Interior Ministry’s special police unit on the absurd charges of cocaine and gun possession. His representatives were ousted from the board of the consortium that controlled the partners’ *oblenerho* stakes.²³¹

Following these events, a private security squad stormed the premises of two *oblenerhos* and ejected Hryhoryshyn’s agents. It did so with the active assistance of police and transportation provided by the Presidential Administration (headed at the time by Medvedchuk).²³² Maksim Kurochkin, representing the Luzhnikovskaya organized crime group, played a key role in this raid. So too did Alexander Babakov, an MP in Russia’s nationalist Motherland Party and another alleged representative of the

²²⁵ Rakhmanin and Mostovaya, “Ukrainian political parties...”

²²⁶ Interview with Respondent #56; Ihor Maskalevich, “Show for oblenergo with court trial and orchestra.” *Zerkalo Nedeli*, February 26-March 4; “V Rossii dumayut, chto Kurochkina zakazala 'luzhnikovskaya gruppa',” *Ukrainskaya Pravda*, 28 March 2007.

²²⁷ “Weekly looks at Russian businessman’s prospects...”

²²⁸ Rakhmanin & Mostovaya, “Ukrainian political parties...”

²²⁹ *Ibid.*

²³⁰ Maskalevich, “Ukrainian specifics...”

²³¹ “Weekly looks at Russian businessman’s prospects...”

²³² Maskalevich, “Show for oblenerho...”

Luzhnikovskaya organized crime group in Ukraine.²³³ According to Hryhoryshyn, the storm troops gave Poltavaoblenerho's manager the proverbial "offer he couldn't refuse" to sign an order for his own dismissal.²³⁴ The new management of the consortium launched a lawsuit against Hryhoryshyn in early 2004 that resulted in the arrest of his shares in virtually all of his companies. A few days later, Hryhoryshyn obtained another court decision reversing the previous one.²³⁵ Later that year, he managed to defend his control of the Zaporizhzhya Transformer Plant against a squadron of machine-gunners sent "to protect a 'minority shareholder' who had bought her thirty-*hryvnyas* worth of stock from an unidentified crook," wrote one incredulous observer. "So there was one machine gunner per UAH 1.5."²³⁶

However, after the Orange Revolution the political balance between the warring factions suddenly reversed itself. Now it was Hryhoryshyn in the ascendant, having backed the winning side, while Surkis and Medvedchuk, who supported the defeated Yanukovych, fell from grace. Hryhoryshyn now seized the opportunity to exact revenge on his rivals.²³⁷ In February 2005, a security team allegedly acting on Hryhoryshyn's behalf tried to take control of Prykarpattiaoblenerho and Poltavaoblenerho by force, expelling managers linked to Surkis and Medvedchuk.²³⁸ Battles for additional *oblenerhos* followed, in many cases resulting in a standoff between competing boards of directors, boards of trustees, and shareholder registries.

The struggle for the *oblenerhos* would continue over the ensuing years. The particular details go beyond the scope of this discussion. But the events described above certainly represented the most dramatic stage. Moreover, by now the reader has likely gotten the main point: having first become rich through soft budget constraints in and around the *oblenerhos*, the political-thug protagonists subsequently engaged in a series of criminal corporate raids against each other's interests.

Surkis's name has been associated with questionable business takeovers even beyond his dealings with Hryhoryshyn. In April 1998, he reportedly bought a controlling stake in the newspaper *Kievskie vedomosti* from its owner after the latter was thrown in jail and the daily evicted from its premises.²³⁹ *Vseukrainskie vedomosti*, another newspaper, was forced to close down just before the 1998 parliamentary elections after losing a libel lawsuit to Surkis and finding itself unable to pay the required damages. Both newspapers had been linked to ousted premier Pavlo Lazarenko.²⁴⁰

Last but not least on our list of plutocratic political thugs is newcomer Yury Ivanyushchenko. A personal friend of Yanukovych from their hometown of Yenakiyev, Ivanyushchenko was allegedly involved in organized crime in Donetsk, including with

²³³ Ibid.; "V Rossii dumayut, chto Kurochkina..."

²³⁴ PR #12. Leonid Amchuk, "Konstantin Grigorishin: Grisha Surkis Govoril, chto Pape Nado Podarit' 10% Cobstvennosti," *Ukrainskaya Pravda*, 13 December 2004.

²³⁵ "Weekly looks at Russian businessman's prospects..."

²³⁶ PR #13. Maskalevich, "Show for oblenergo..."

²³⁷ Ibid.

²³⁸ PR #14. "V Ukraine Poyavitsya Spetspodrazdelenie po Bor'be s Reiderami," *Ukraina Kriminal'naya*, 22 September 2006.

²³⁹ PR #15.

²⁴⁰ "Kuchma – Enemy of Free Press?" *Eurasia Daily Monitor*, 6 May 1999; Viktor Luhovyk, "Ukraine: Newspaper Shuts Down After State Seizes Bank Account," *RFE/RL*, 9 March 1998.

groups implicated in several high-profile assassinations.²⁴¹ After Yanukovich's election as President in 2010 he graduated to bigger domains, becoming a parliamentary deputy for the Party of Regions. He has had to repeatedly deny reports that he has a role in Khib Investbud, the state-owned grain trader. Khib Investbud benefited mightily in 2011 after the government once again restricted grain exports and imposed quotas. A huge portion of these quotas went to Khib Investbud along with a monopoly on the right to sell grain to the national reserve. While most other producers had to pay for their quotas, Khib Investbud received its for free. Whether this had anything to do with Ivanyushchenko's admittedly "comfortable and friendly relationship" with Mykola Prysyzhnyuk, the Minister of Agriculture, is anyone's guess. If true, the allegations that Ivanyushchenko profited from the scheme would implicate him in the siphoning of state assets through lucrative soft budget constraints.²⁴² Termed the "Great Grain Robbery" by Morgan Williams of the U.S.-Ukraine Business Council, it is unclear where this episode ranks in comparison with the multiple other great grain robberies in post-Soviet Ukrainian history.

Not content with stealing state resources, Ivanyushchenko, according to rumors, has turned his attention to private assets as well. Volodymyr Nemirovsky, owner of Stalkanat-Silur, a manufacturer of wire products, claims he suffered an attempted raid by a Donetsk businessman, Ivan Avramov, whom Nemirovsky believes was backed by Ivanyushchenko. Nemirovsky and his company began facing various state actions including the opening of criminal cases along with the seizure of documents and equipment. He then received a visit from representatives of Avramov who claimed they could make all of these problems disappear if Avramov was granted a stake in Stalkanat-Silur.²⁴³ Some believe that plutocrat Oleksy Vadatursky, who had built up Nibulon into a highly profitable agricultural operation, was a victim of another raid by Ivanyushchenko. While Vadatursky would not confirm it, rumors circulated that the raid was orchestrated by Ivanyushchenko's people who forced Vadatursky to hand over a stake in Nibulon.²⁴⁴

Political Thugs or Crony Capitalists? Uncertain Cases

For a number of individuals, I was not able to obtain enough information to determine if they are political thugs or crony capitalists. We have already considered Leonid Yurushev. Another is Ivan Huta, a former collective farm head and official in the Husyatyn Regional Committee of the Communist Party of Ukraine. In 1992, he founded Mriya ("Dream") Agroholding, which began producing agricultural goods on land it leased from the state. If a recent scandal is any guide to how his business grew over the years, Mriya has benefitted from a wide range of soft budget constraints thanks to shady accounting practices and the goodwill of local authorities. According to details of a 2013 investigation, Huta and Mriya falsely reported their taxable incomes. Mriya also failed to register over 20 percent of its contracts for leasing agricultural land from the state

²⁴¹ Kuzio, "Ukraine Moves to State Capitalism..."; "Yanukovich Provides a Krysha..."

²⁴² "Ivanyushchenko, Yanukovich's acquaintance, denies ownership in Khib Investbud," *Kyiv Post*, 21 April 2011; "Business Sense: Time to remove unfair barriers that stifle agricultural sector," *Kyiv Post*, 21 April 2011.

²⁴³ PR #16. Serhiy Leshchenko, "Vladimir Nemirovskii: Pomeniali Tol'ko Kostiumy - s Adidas na Brioni. I Vmesto Beisbol'nyx Bit - Teper' Prokurory i Mvd," *Ukrainskaya Pravda*, 28 February 2012.

²⁴⁴ Daria Isakova, "Geroi Ukrainy, Vrag Gosudarstva," *Forbes Ukraina*, 18 May 2012.

(private ownership of land in Ukraine remains restricted, and so agricultural companies must generally lease it from the authorities). It owes substantial arrears on rent payments for much of this land. Due to benevolent treatment from local authorities, "[h]undreds of thousands of hectares of land resources, the reserve fund, and lands of historical and archeological sites were used by Mriya without the relevant agreements, approvals, and contracts." An EBRD director allegedly overlooked false valuations of Mriya's assets when in 2011 he agreed to have the bank loan \$25 million to the agricultural holding.²⁴⁵

However, not everyone who provides Mriya with soft budget constraints is necessarily aware that they are doing so. In 2008, twenty percent of the company was sold in an IPO on the Frankfurt Stock Exchange. Much of the money was raised only because of what one report described as a "massive fraud" that vastly inflated the company's assets and turnover. This was a soft budget constraint to the extent that it gave Mriya access to financing that was not justified on the basis of its assets and sales.²⁴⁶ Nevertheless, I could not find enough information about Huta's early career to determine if his wealth derived exclusively from soft budget constraints or if his companies actually produced any real economic value.

Oleh Bakhmatyuk, another plutocrat, made his way in business at KGD, a gas trader in Ivano-Frankovsk, where he served as Commercial Director until 2001. KGD was an official representative of the notorious Gazprom subsidiary, Itera, buying gas from Itera and selling it to Ukrainian customers. He later served as the deputy head of Naftohaz Ukrainy, that perennial source of siphoning for legions of Ukraine's powerful political thugs. After leaving KGD, he established Avangard, a successful agricultural operation, mostly by purchasing bankrupt companies and turning them around.²⁴⁷ Whether he should be considered a political thug or just a crony capitalist is somewhat uncertain. He got the job at KGD when he was only twenty years old as a result of his political connections. He founded his Carpathian Finance Company also with the help of his connections. The gas trade remained crucial to his success; he privatized a number of *oblenerhos*. Even Avangard has drawn serious questions concerning its business practices, such as converting the interest on state loans into capital in lieu of payment. Competitors often feel intimidated about speaking out.²⁴⁸

Bakhmatyuk been linked to at least one raid. The takeover in question targeted Serhiy Maksimov, a minority shareholder in VAB Bank.²⁴⁹ Maksimov had once been the majority shareholder but the bank ran into deep trouble during the 2008 financial crisis. It had to be rescued through the sale of a controlling stake to the Dutch group TBIF. After concluding the deal with Maksimov, TBIF realized, to its great displeasure, that a sizable chunk of VAB's non-performing assets consisted of loans to Maksimov's own companies. After failing to recover these debts, TBIF wanted out. It found a buyer for its stake in Oleh Bakhmatyuk. Upon his arrival to VAB, Bakhmatyuk suddenly

²⁴⁵ Semen Lyuty, "Pomstva Ivana Huta," *KhairVei*, 5 March 2013.

²⁴⁶ Ibid.

²⁴⁷ "Oleg Romanovich Bakhmatyuk," *Ukrainskii biznes resurs*, accessed 9 August 2014 (<http://bp.ubr.ua/profile/--61>).

²⁴⁸ Dariya Isakova, "Biznes vkrutuiu," *Forbes Ukraina*, 22 May 2012 (<http://forbes.ua/magazine/forbes/1332586-biznes-vkrutuiu>); "'Kidok' 'na pososhok': Vladimir Matvienko zalez v karman aktsioneram 'PIBa'," *Ukraina kriminal'naya*, 4 July 2008, accessed 9 August 2014 (http://cripo.com.ua/index.php?sect_id=2&aid=55984).

²⁴⁹ PR #17

announced that the total debts owed to the bank by Maksimov's companies amounted to nearly UAH 1 billion. TBIF itself expressed shock at this figure, claiming it to be far greater than anything it had uncovered in its own investigation. To make matters worse, in October 2011, Maksimov, while perusing the news at a Kyiv café and sipping coffee, came across an article stating that he was being prosecuted for stealing money from VAB. If found guilty, he faced up to 12 years in prison.²⁵⁰

Ordinarily, it can be difficult to determine if such judicial proceedings are legitimate or have instead been illegally engineered by raiders. However, a key clue emerged in 2010 suggesting that it was indeed part of an attempted criminal corporate raid. In December of that year, the Kyiv Commercial Court ruled that a building owned by Maksimov should be transferred to VAB in lieu of unpaid debts. The only problem was that the judge who had supposedly handed down this ruling happened to be away on maternity leave at the time and could not have possibly issued the decision. In other words, the court judgment was apparently fabricated. The illegal use of an agent of force qualifies the case as a criminal corporate raid, and the attempted elimination of Maksimov from VAB most certainly was that.²⁵¹

For Petro Poroshenko, another plutocrat and Ukraine's recently-elected President, it is likewise unclear whether he should be considered a political thug or merely a crony capitalist. He built a large business empire spanning shipping, automobile production, and confectionaries. However, it is uncertain where this empire would be if not for its privileged access to soft budget constraints; "[e]conomic experts (as well as tax and law-enforcement officials) have every reason to believe that his chocolate-automobile-shipment empire has grown by leaps and bounds not because of the entrepreneurial talent of its manager," according to one report. Before he became the country's President, Poroshenko was a long-standing MP in parliament. There, he variously served on key committees whose decisions could directly impact his businesses. In addition, when it came to enacting new laws and regulatory changes that would benefit Poroshenko, the Ukrainian parliament showed it could act with astonishing efficiency. For instance, in the late 1990s his Ukrprominvest bought a large stake in the Verkhnedneprovsk Starch Plant, which had a monopoly in the starch market. In February 2000, an extension of import-duty exemptions on seed corn for the food industry passed the parliament and was signed into law "in an unprecedentedly short period of time – 15 days – while many sorely needed economic bills had been waiting in line for years. This is but one of many similar examples," according to one journalist. According to a 2003 article, from 1998 to 2003, Roshen, Poroshenko's confectionary, managed to understate the value of imported goods, evade VAT payments on these goods, and make improper tax declarations regarding foreign loans.²⁵²

Poroshenko has been implicated in a wide range of corruption-related scandals, including but not limited to raiding. He was a prominent supporter of Yushchenko's presidential campaign in 2004. But in 2005, as rival camps in the Orange Coalition descended into open conflict, Poroshenko became the subject of five separate investigations by the General Prosecutor. One of these alleged that he had been behind a

²⁵⁰ "Konflikt vokrug VAB Banka: chto ostalos' za kadrom," *Forbes Ukraina*, 22 November 2012.

²⁵¹ *Ibid.*

²⁵² Natal'ya Nakhimenko, "Gryaznaya biznes-imperiya Petra Poroshenko," *Ob'ektivnaya gazeta*, 3 August 2003, accessed 9 August 2013 at <http://stringer-news.com/publication.mhtml?Part=37&PubID=3733>.

raid on two companies constructing a high-rise building in Kyiv. The company owners claimed that representatives of Poroshenko threatened to have the authorities shut down the project unless they gave him a stake in it. When they refused, Poroshenko allegedly followed through on the threat.²⁵³

In another raid attempt, Poroshenko and other top-level officials in the National Security and Defense Council (NSDC) reportedly summoned an appeals-court judge to demand that he re-open a bankruptcy against the Severodonetsk AZOT Plant.²⁵⁴ This was despite the fact that the judge had already closed the case after the factory had settled its debts. According to the allegations, they told the judge that his appeals court would be dissolved by presidential decree if he did not agree to reopen the bankruptcy proceedings.²⁵⁵ Like the alleged threats against the construction project, this case too became the subject of a criminal investigation. However, only days after the cases were announced, President Yushchenko intervened and fired the officials heading the investigations, including the General Prosecutor and the head of the Security Service. Needless to say, all proceedings against Poroshenko were subsequently dropped.²⁵⁶

Another uncertain case is Tarel Vasadze. He acquired a controlling stake in auto-maker AvtoZaZ, which held a near-monopoly position on the domestic car market. Renamed UkrAvto, it has become the sole authorized Ukrainian dealer for Chevrolet, Daewoo, and Opel automobiles. I cannot label him a political thug, as I remain unsure of the particular way in which he won the AvtoZaZ privatization. But various scandals surrounding the company do point in that direction. In March 2011, law-enforcement got wind of a giant scam at the company's customs terminal in Ilyichevsk. Under the scheme, imports coming through Ilyichevsk could obtain customs clearance only at the customs terminal located at AvtoZaZ. Meanwhile, regional authorities would accept payments of customs duties from Vasadze's companies only. This meant that any business owner wishing to import goods through the port had to go through Vasadze, which naturally required paying a "fee."²⁵⁷

While the ranks of Ukraine's plutocratic elite are filled with political thugs, not all of them, or even a majority, fall into this category. To begin with, there are a number of actors on the list who can be considered crony capitalists; while political connections certainly played a role in their early business success, it also came about as a result of a major capital investment. In most instances, the investment took the form of restructuring a communist-era firm into a viable, productive enterprise after privatizing it.

One of the most notable examples is Viktor Nusenkis. Nusenkis was the director of a Donetsk coal mine during the late Soviet era. During perestroika he founded DON, a

²⁵³ PR #18. "Ukrainian ex-security supremo accused of serious crimes;" (Varfolomeyev 2005a).

²⁵⁴ PR #19

²⁵⁵ Alexandra Prymachenko, "No Corruption on the Top." *Zerkalo Nedeli*, September 24-30, 2005

²⁵⁶ "Ukrainian ex-security supremo accused of serious crimes." *BBC Monitoring Ukraine & Baltics*, November 3, 2005; Varfolomeyev, Oleg. 2005a. "Ally Cleared of Criminal Charge - A Trap For Yushchenko?" *Eurasia Daily Monitor*, 26 October 2005.

²⁵⁷ Nina Mishchenko, "Korporatsiya 'Bogdan': iz reanimatsii – v morg," *Forbes Ukraina*, 19 May 2014 (<http://forbes.ua/magazine/forbes/1370692-korporaciya-bogdan-iz-reanimacii-v-morg>); "Ot perestanovki rukovoditelei korrupsionnye skhemy ne menyaiutsya?" *URA-Inform*, 15 March 2011, accessed 9 August 2014 (<http://ura-inform.com/ru/economics/2011/03/15/perestanovka>); Lesya Zhashkova, "Navar na brendovom 'zheleze'," *Oligarkh.net*, 11 March 2008, accessed 9 August 2014 (<http://oligarh.net/?actually/32271/>).

management company for state-owned mines. He concluded an arrangement with the State Committee for the Coal Industry that gave DON responsibility for financing and managing coal mines. In return, DON was granted the right to sell the coal. To be sure, Nusenkis could not have entered into such a role if it were not for his political connections. But instead of imitating similarly well-connected individuals at the time who set about pillaging the state enterprises they controlled, Nusenkis turned his mines into productive business enterprises. He also supplied his workers with food, medical supplies, and other scarce consumer essentials, gaining their fierce loyalty in the process. Building on the success of DON, Nusenkis then founded Energo, which became the largest coal trader in Ukraine. But it did not hold this position for long; from 1994 onward Energo was pushed out of the coal sector by the much more aggressive ISD.²⁵⁸

Down but not out, Nusenkis now set his sights on building a vertically integrated structure that combined the production of coal, coke, and steel. In 2000 Energo privatized several beleaguered state enterprises including the Red Army Mine No. 1, the Yasinovsky and Makeyevsky coke plants, and the Donetsk Metallurgical Plant. Over the next several years he turned these dysfunctional assets into one of the country's biggest steel-making operations.²⁵⁹

In Ukraine's treacherous business environment, Energo could not have developed as it did without political protection. It was for this purpose that Nusenkis brought in Donetsk political heavyweight Hennady Vasylyev, who variously served as chief prosecutor of Donetsk as well as Ukraine as a whole. Thanks to his role in Energo, Vasylyev would himself become one of the country's richest businessmen. In contrast to Nusenkis, however, Vasylyev did not bring much business talent to the game; his main asset was his political influence. Being a political thug, he eventually showed himself a worthy player in that singular activity to which political thugs so often gravitate: criminal corporate raiding. As we saw earlier, Vasylyev threatened to take down Energo and with it Nusenkis unless he was formally granted the 50 percent stake he believed was his due.²⁶⁰

The Failure of Property Rights Institutions in Ukraine

Recall that there are two main dependent variables in this study: the frequency of raiding and the strength of property rights institutions. As the preceding discussion should make abundantly clear, Ukraine lacks effective legal property rights institutions. No country where such gross and systematic abuses of property are so frequent can legitimately claim to possess robust and impartially enforced legal property rights. If Ukraine had such institutions, the legions of examples provided above could not have happened in the first place.

The reason for the weakness of Ukraine's property rights institutions is not just the strong position of political thugs but also that of crony capitalists. Even if raiding tends to be the work of political thugs only, a high proportion of crony capitalists can still obstruct the formation of effective property rights institutions. This remains true even if the business elite is by and large devoid of political thugs. The reason is that, similarly to

²⁵⁸ "Krysha na milliard."

²⁵⁹ Ibid.

²⁶⁰ Ibid.

political thugs, crony capitalists too use corruption in pursuit of profits. As long as business actors, whether in the form of political thugs or crony capitalists, are constantly tempting state officials with bribes, the emergence of effective institutions becomes profoundly difficult to achieve. We should especially expect this to be true in early capitalist contexts, where state officials tend to be poorly paid and state institutions remain in a constant state of flux.

Thus, the strength of property rights institutions depends not simply on the scarcity of political thugs but also that of crony capitalists. The prevalence of entrepreneurs is not so relevant, especially among the non-plutocratic elite. Any country can be expected to have a lot of entrepreneurs; if one were to take a head count of all business owners in Ukraine, entrepreneurs would likely outnumber political thugs and crony capitalists by a large number. The point is that Ukraine – like Poland and Slovakia but unlike Estonia – is marked by the presence of many political thugs and crony capitalists among the non-plutocratic elite whose dense ties to officialdom has helped them obtain positions of great wealth and prominence. The plutocratic elite, meanwhile, is completely dominated by these two actor-types.

This study proposes the argument that, to become effective, new property rights institutions require the prior marginalization of the wrong kinds of actors. If ever there was a case for this proposition, Ukraine is it. If Ukraine's property rights institutions remain weak and its regulations stiflingly complex, it is because the crony capitalists and political thugs who dominate the elite have made them this way. Breaking from the typical politeness of public diplomatic statements, José Manuel Pinto Teixeira, the European Union's top representative in Kyiv, complained in 2009 that "corruption, red tape, administrative obstacles of every kind – these are only things that serve the interests of those who today control the economy because they do not want competition. They are allergic to competition."²⁶¹ If we seek to understand the causes and proper remedies for weak property rights institutions, we cannot focus only on what the rules say and how they are enforced; we also need to address the corrupt status-quo actors who stand in the way of forging these institutions and whose influence must be reduced if any real reform is to take place. Where political thugs, crony capitalists, and their corrupt supporters in government hold sway, they will actively sabotage the formation of effective institutions. They will first engineer the adoption of rules that allow them to continue abusing others' property rights. Failing that, they will systematically undermine the enforcement of the rules or alternatively enforce them selectively against rivals and takeover targets.

To see how this occurred in Ukraine, we must first consider how corrupt actors deliberately structured the rules to facilitate the abuse of property rights. We must then examine how they created arrangements for manipulating the way the rules are enforced.

To begin with, Ukraine's notoriously byzantine legal and regulatory framework, packed as it is with mutually contradictory rules, did not arise out of nowhere. The corrupt ex-communists who have been in charge of drafting these rules since independence deliberately rendered them overly complex and mutually-contradictory in the first place. They thereby created a situation in which any businessperson, however well-intentioned, is likely to be in violation of some law at any given time. Thanks to this fact, political thugs and their bidders in the state administration are always be able to find a convenient legal pretext to inspect, fine, detain, or prosecute any person or entity

²⁶¹ "A decision of despair," *Financial Times*, 6 January 2010.

they need to. One of my sources, a businessman in the agricultural sector, complains of “petty officials who are constantly harassing you” on the basis of any number of myriad regulations with which a business must comply. He is visited five times a week by these officials and each one of them has the power to shut down his business.²⁶²

In addition to devising an excessively complex system of rules, the predators who run Ukraine work to tailor specific rules to their particular advantage. A new law on public procurement was adopted in 2010. But, in a provision that was convenient for certain influential oligarchs, it exempted the huge infrastructure investment projects for the 2012 European soccer championship from the new rules. The tax code passed the same year heralded major tax cuts for large corporations, cuts that were paid for by ramping up the tax burden on small businesses. And, as we have already seen, successive governments have imposed sudden and drastic limitations on grain exports, albeit with the proviso that the limits can be lifted in “certain cases.”²⁶³

Similarly, in October 2006 parliament voted to lower the threshold for meeting a quorum in the general assembly of a joint-stock company from 60 to 50 percent. Kirill Andryanov, a partner at a major law firm, referred to the move as “hasty” and “serving the interests of certain business groups” and in particular “industrial tycoons from Eastern Ukraine.”²⁶⁴ Commercial lawsuits against a given company or shareholder can be filed in any district court in the country, however distant that court is from the jurisdiction where the alleged violation occurred. The aim is to let the plaintiff sue wherever he happens to have a reliable judge in his pocket. Another rule gives a minority shareholder with at least 40 percent ownership more extensive rights than such shareholders ordinarily receive. This creates havoc at many companies and makes criminal corporate raids all the more easy to execute.²⁶⁵

The new Law on Joint Stock Companies, which came into effect in early 2009, sought to correct many of the problems in Ukrainian corporate governance law. It was hailed by legal experts as a major improvement. Among other changes, it requires that notice of a shareholders meeting be sent to all shareholders at least 30 days in advance and meetings be held only at the company’s registered address. It also creates greatly enhanced protections for minority shareholders.²⁶⁶ Nevertheless, as the numerous examples in this chapter demonstrate, criminal corporate raiding has continued apace even though the prevention of such illegal takeovers was the primary rationale behind the law’s adoption.

Even where the integrity of the law is not in question, that of the law enforcers certainly is. One reason for the general absence of honest and dutiful law enforcers in Ukraine is that the criminals who dominate the political system tend to prevent their appointment in the first place. Not that honest candidates frequently seek such appointments anyway given the dangers that confront any official who actively and impartially carries out her lawful tasks. A case in point is Andriy Kozhemyakin, the former deputy head of the Security Service (SBU) and chief of its Main Department for Fighting Corruption and Organized Crime. Despite - or because of - his solid reputation

²⁶² Interview with Respondent #59.

²⁶³ “Yanukovych ‘reforms’ favor mainly oligarchs,” *Kyiv Post*, 13 May 2011.

²⁶⁴ Jim Davis, “Corporate Raiding, Post-Soviet Style.” *The Ukrainian Observer*, November 2006.

²⁶⁵ Interview with Respondent #2

²⁶⁶ “Law brings new rules for business,” *Kyiv Post*, 13 November 2007.

as a legitimate corruption fighter, he was accused in 2006 of participating in a scheme to destroy evidence against Semyon Mogilevich. At the time, he had been investigating corruption around RosUkrEnergo. The Prosecutor General who launched the case was Oleksandr Medvedko, who has close links to shady businessmen from Donetsk. A district court later ruled that the charges against him were filed illegally.²⁶⁷ But that does little to dispel the danger faced by honest law enforcers working in a henhouse guarded by the fox.

Further examples abound. In 2003, former Deputy Prime Minister Leonid Kozachenko was arrested, most likely for supporting reforms that would have reduced state control over the agricultural sector.²⁶⁸ In 2006, Roman Yerokhin, a senior officer in the SBU's Directorate for Fighting Organized Crime, was kidnapped and murdered. Prior to his death, Yerokhin had been investigating money laundering in the purchase and sale of spots on the Party of Regions' party list (which determines who gets to represent the party in parliament). According to Lutsenko, the former Interior Minister, the hit was ordered by an MP connected to the Donetsk financial establishment. However, instead of bringing the suspected MP in for questioning, Medvedko, the General Prosecutor with ties to the Donetsk elite, focused instead on interrogating the investigators themselves.²⁶⁹

Being that honest law enforcers are marginalized, it should come as no surprise that the most egregious violators of property rights never get punished. Until very recently, Pavlo Lazarenko was the only senior Ukrainian official to have ever been tried and sentenced, and this occurred in a US court, not a Ukrainian one (the only other one is Yuliya Tymoshenko).²⁷⁰ This is because the political thugs and crony capitalists who dominate Ukraine's business and political scenes do not want to set a potentially dangerous precedent; if you prosecute your enemy today, you may suffer the same tomorrow. They instead prefer a legal environment they can easily manipulate. This is the same reason why agreements with international bodies to render administrative procedures more transparent have consistently come to naught.²⁷¹

The courts, for their part, are notoriously corrupt. "Bribes are taken by everybody from [the] chairman of the court to judge[s'] assistants," says one attorney. Not only that, the powers-that-be in the judicial system make sure things stay that way; "if one doesn't take bribes, this person doesn't work in the court system," the attorney notes. After all, ensuring that your subordinates are corrupt better enables you to control them since this puts them at your mercy. "They never allow anyone they do not control to become a judge," another attorney confirmed. Tatyana Montyan, a lawyer and public advocate against judicial corruption, claims that "political groupings have divided quotas for [the] appointment of judges; they simply determined that a particular political force will have influence on particular judges." Nor are lawyers willing to testify against corrupt judges. One prosecutor who investigates judicial corruption complains that "I never met a lawyer

²⁶⁷ "Corporate raids show state failing business," *Kyiv Post*, 18 February 2010; "Ex-SBU Deputy Chief Kozhemiakin Denies PGO's Allegations Of Involvement In Liquidation Of Case On Mogilevich's Activities." *Ukrainian News*, March 25, 2006; "Court Declares Filing Of Criminal Case Against MP Kozhemiakin (Tymoshenko Bloc) In April Illegal." *Ukrainian News*, October 12, 2006.

²⁶⁸ Ivan Khokhotva, "Notes from Ukraine: Grain is Grain." *Transitions Online*, April 9, 2003; Peter Byrne, "Leonid Kozachenko Freed, Protests Innocence, Prepares for Trial." *Kyiv Post*, June 19, 2003

²⁶⁹ "Cop murder puts new Cabinet at odds." *Kyiv Post*, September 14, 2006.

²⁷⁰ *Eurasia Daily Monitor*, 14 January 2009.

²⁷¹ Hans van Zon, *The Political Economy of Independent Ukraine* (New York: St. Martins, 2000), 28.

who gave testimony against a particular judge. They want to live and work in this country.” Nevertheless, the problem is not so much the judges as the abundance of actors who actively seek to corrupt them. “Two-thirds of the time, it’s the lawyers who promote corruption in [the] courts,” the prosecutor says, at times going so far as to stuff cash into the pockets of reluctant judges.²⁷²

A further example demonstrates how the adoption of even the soundest and most well-intentioned laws can falter under the weight of entrenched criminal interests. In 2010 a rule came into force that mandates the random assignment of cases to individual judges. This replaces the old system by which the chairman of a court could arbitrarily assign a particular case to the “right” judge. Even though the law is perfectly clear and well-written, political thugs and crony capitalists have still found a way around it. The devil, of course, is in the details. In cases where the computer program that manages the random assignment “breaks down,” the judicial administration allows the court chairman to allocate cases manually and without explanation. Meanwhile, the default option in the software is for the manual, not random, assignment of cases. As one might imagine, this is a perfect recipe for the continuation of the corrupt old ways. And it is a recipe cooked up by the corrupt interests who control the judicial system. Asked by a reporter to provide a numerical breakdown of the frequency with which cases are assigned manually rather than randomly, Olena Meleshak, the head of the Shevchenkivsky District Court in Kyiv, replied that, unfortunately, this is not “public” information. What she neglected to add is that the definition of what is and what is not “public” is entirely up her, as it is to any court chairman.²⁷³

Business professionals constantly complain about the corruption of Ukraine’s property rights institutions. One of my respondents, a consultant who advises businesses on dealing with the authorities, told me there can be no specialization in his job (i.e. specializing in relations with the tax administration only, or the courts only). This is because “minor engagements with any one part of the government can balloon to involve other parts and other issues. And the government can kill any business at any time.”²⁷⁴ Another notable indication that property rights are weak is the widely-reported fact that, in Ukraine, the question of who formally owns the shares in a company is of no particular importance; what really matters is who has de facto control.

The pervasiveness of criminal corporate raiding, then, is hardly the only evidence for the feebleness of Ukraine’s property rights institutions. This condition is the direct result of the country’s unfortunate surplus of political thugs and crony capitalists.

Conclusion

The overthrow of President Yanukovich in the second popular uprising in ten years is unlikely to bring about any fundamental change in the structure of Ukraine’s political economy. The simple reason is the continued dominance of political thugs and crony capitalists among the business elite. After all, the country just witnessed the election of one such shady oligarch as its new President.

²⁷² “Despite high-profile arrests, corruption still dogs courts,” *Kyiv Post*, 14 May 2009.

²⁷³ “Courts flout case selection law for judges,” *Kyiv Post*, 1 March 2012.

²⁷⁴ Interview with Respondent #5.

Yanukovich's ouster, at least for a time, will indeed sideline many of the economic criminals who had hitched their wagons to his rule. However, their enduring power and presence among both the plutocratic and non-plutocratic elites will merely ensure that new ones arise in place of the old – unless this or future governments carry out a dramatic program of hard budget constraints.

This chapter has shown the process by which political thugs came to dominate much of the economy of early capitalist Ukraine. The marginalization of revolutionaries and the elite-led nature of the transition placed the country on a path toward rampant raiding. The sidelining of Rukh in favor of the ex-communist nomenklatura during the transition set the stage for this outcome by forestalling any and all attempts by post-communist governments to implement hard budget constraints on firms. Had a revolutionary opposition like Rukh taken full control of power during the transition *and* resolutely hardened budget constraints on firms, these political thugs would have found themselves out in the cold. Such an outcome would also have created the possibility for the ousted communist party to regenerate itself into a modern social democratic one, thus laying the foundation for robust party competition. This, in turn, would have constrained post-communist leaders from privatizing the state's crown jewels to their cronies.

Alas, nothing of the sort occurred. Consequently, from the early 1990s a nascent class of political thugs found ample opportunities to siphon state assets through the continual provision of soft budget constraints. Practically all of the political thugs who would come to dominate the business world grew wealthy in this period either by siphoning gas from the state and consumers, tunneling assets from state enterprises, or both. They also benefited from myriad other soft budget constraints ranging from direct state subsidies and cronyist financing to special tax breaks. On top of that, Kuchma practically gave away the biggest state enterprises to the political thugs who supported him and the parliamentary opposition was not nearly strong enough to stop him. Often the beneficiaries of Kuchma's privatizations were same ones he had previously appointed to manage the enterprises.

Having enriched themselves through the theft of state assets, the political thugs who came to dominate both elite strata embarked on second careers as criminal corporate raiders. Meanwhile, the prevalence of both political thugs and crony capitalists deprived new property rights institutions of the space they needed to establish their authority. With so many political thugs and crony capitalists constantly acting to subvert them, these institutions never stood a chance.

On the one hand, the evidence from this chapter confirms the validity of the conventional approach in social science, which looks at the way institutions influence actors; soft budget constraints were responsible for granting corrupt business actors such a dominant place in society. But it likewise demonstrates the importance of going beyond the conventional view to look at how actors shape institutions. Actors played a prominent role in two respects. First, the ex-communists who survived atop the country's political structures took action to ensure the liberal availability of soft budget constraints in the first place. Second, the political thugs and crony capitalists who arose on the back of soft budget constraints enfeebled property rights institutions by actively seeking to render them weak and easily-manipulated. Attempts to put better-designed rules into place faltered as criminal economic and political interests subordinated them to serve the accumulation of further wealth.

“Istrokapitál, and particularly [Zoroslav] Kollár, who worked very closely with them, tended to use this kind of operation. And he also helped to set up Penta and J&T. So that’s why I say there were some incestuous relations between these three even though they acted later on as if they were independent players. But there were similar minds behind the setup of the companies and they functioned in similar ways. And they all involved to some extent a transformation from the investment funds.”

—Respondent #47¹

Chapter Five

Slovakia: Incestuous Relations

On November 17th, 1989, riot police acting on behalf of the Communist Party of Czechoslovakia broke up an anti-government student demonstration in Prague. If communist officials thought this would contain the revolution that had started in East Germany from reaching their own country, they would be sorely mistaken. The repression of the demonstrators dramatically backfired, prompting hundreds of thousands of citizens to flood into the streets of the capital. Within days, the communist regime would be gone. If, in Ukraine, the regime transition was managed by the nomenklatura, this would not be the case in Czechoslovakia. There, the entire communist establishment was swept from power by a revolutionary opposition - without any formal negotiations between opposition and regime. Revolutionary parties won clear majorities at both the federal and Slovak levels in the June 1990 parliamentary elections.²

Despite the stark contrast in their founding experiences, many specialists would be surprised to learn how little the political economies of post-communist Slovakia and Ukraine really differ. Slovakia seemingly had much going for it. It lies at the heart of Europe, its capital, Bratislava, a short drive from Vienna. For most of its post-communist history it has had a functional democratic regime. It underwent radical economic liberalization in the early 1990s, was an early entrant to the European Union, and has a vigorous free press.

Yet the extent of economic criminality there makes it virtually indistinguishable from Ukraine. As in Ukraine, criminal corporate raiding has become pervasive among

¹ Interview with the author, 2007

² Petr Jehlička, Tomáš Kostecký, and Luděk Sýkora, "Czechoslovak Parliamentary Elections 1990: Old Patterns, New Trends and Lots of Surprises," in *The New Political Geography of Eastern Europe*, ed. John O'Loughlin and Herman van der Wusten (London: Belhaven, 1993), 240.

Table 5.1. Slovakia's Plutocratic Elite

Name	Alleged Type	Raiding?
Andrej Babiš	CC	
Štefan Rosina, Jr.	CC	
Vladimír Soták	CC or E	
Martin Blaškovič	CC or E	
Rudolf Hrubý	E	
Peter Paško	E	
Miroslav Trnka	E	
Peter Vajda	E	
Jozef Tkáč	PT	X
Marek Dospiva	PT	X
Jaroslav Haščák	PT	X
Milan Fiľo	PT	
Mario Hoffman	PT	X
Martin Kúšik	PT	X
Ivan Jakabovič	PT	X
Ivan Kmotřík	PT	
Patrik Tkáč	PT	X
Zoroslav Kollár	PT	X
Branislav Prieložný	PT	X
Anton Siekel	PT	X
Jozef Oravkin	PT	X
Peter Korbačka	PT	X
Juraj Kamarás	PT	
Juraj Široký	PT	X
Ján Slota	PT	
Vladimír Poór	PT	
Ivan Lexa	PT	
Vladimír Lexa	PT	X
Alojz Lorenc	PT	X
Ladislav Krajňák	PT	
Radovan Vítek	PT	X
Jozef Brhel	PT	
Lubomír Blaško / Mária Blašková	CC or PT	
Ivan Chrenko	CC or PT	

Raiders	% of Pluto Elite
Raiders	47.1%
Possible Raiders	n/a
Actor-Types	
E	11.8%
E or CC	5.9%
CC	5.9%
CC or PT	5.9%
PT	70.6%
Entrepreneurs	11.8% to 17.6%
Crony Capitalists	5.9% to 17.6%
Political Thugs	70.6% to 76.5%
CC & PT Combined	76.5% to 88.2%
Key	
CC = Crony Capitalist	
E = Entrepreneur	
PT = Political Thug	

both the plutocratic and non-plutocratic elites. Forty-seven percent of plutocrats have been linked to raiding while non-plutocrats have committed raids in eight of nine economic sectors. For comparison, 35 to 45 percent of Ukraine's plutocrats have been associated with raiding and non-plutocrats have carried out raids in seven sectors (Tables 5.1 and 5.2). These numbers are far higher than in Poland (13 to 15 percent of plutocrats and seven sectors) and Estonia (5 to 11 percent of plutocrats and two sectors). As in

Ukraine, moreover, the key institutions charged with protecting legal property rights remain weak, subject to manipulation and subversion by well-connected criminals.

The current chapter will offer up a series of astonishing stories showing the full range of economic criminality, graft, intimidation, and expropriation in post-communist Slovakia perpetrated by a group of sinister and nefarious political thugs. It will explain how it was that these actors came to dominate so much of the business world. It will also detail the ways in which they conspire with politicians, judges, police, regulatory officials, and organized crime groups to expropriate the property of others and keep the rule of law weak.

The wholesale replacement of the communists by a revolutionary government left Slovakia with the right structural conditions in place to avoid the ascendance of political thugs and crony capitalists and establish the basis for sound property rights institutions. The transition from communist rule occurred while Slovakia was still a part of the Czechoslovak federation. Both the federal government in Prague and the regional administration in Slovakia would fall into the hands of a revolutionary opposition. For the most part, the change of regime at both levels was an example of full-scale replacement. In this regard, Slovakia began from a starting point that was quite similar to Estonia's.

The key difference between the two countries thus comes down to agency. Slovakia's early post-communist leaders failed to take sufficient action to institute hard budget constraints. Had they done so, the rise of political thugs and crony capitalists might have been averted; deprived of easy credit, subsidies, and tax breaks, few such actors could have established lasting careers in business. Alas, the imposition of hard budget constraints is to a large extent a matter of choice, at least for new governments that come to power through the replacement of the old regime. And it was a choice that the post-communist leadership would not take adequate steps to carry out.

But did Slovakia not face certain structural impediments to imposing hard budget constraints? One possible obstacle was the presence within the Slovak revolutionary coalition of ex-communists who had been purged in 1968 following the crushing of the Prague Spring by Soviet forces. This could have placed constraints on the ability of the new government to implement hard budget constraints. But the revolutionary forces who took power in the Czech Republic were free of such ties to the former nomenklatura. And yet they still failed to take adequate measures to push through hard budget constraints.³

What about the higher-than-average importance of heavy industry to the Slovak economy? Might that have led its leaders to avoid hard budgets for fear of the massive social dislocations that could result? The Estonian economy likewise had a large presence of heavy industry (Table 5.3), even if was not quite as high as in Slovakia. And yet Estonia's leaders nevertheless carried out a radical program of hardening budget constraints.

³ Gould, 55-102.

Table 5.2. Alleged Non-Plutocratic Raids

Raid #	Target	Sector	Alleged Perpetrator	Pol. Thug?
1	Tesla Stropkov	2	HZDS	?
2	NCHZ	2	Anna Nagyová and family	Yes
3	IRB	6	VSZ	Yes
4	Incheba	9	IMBA	?
5	Glance House	7	Marián Kočner	Yes
6	TV Markíza	5	Gamatex/Marián Kočner	Yes
7	Concrete panel factory	2	Mikuláš Černák	Yes
8	Drukos	8	Mikuláš Černák	Yes
9	Nitra Sugar Factory	2	HZDS/Ľuboš Ferus	Yes
10	Ján Vovčík's farm	1	Kalná Roztoka mayor, Andrej Fedorko, Ján Glogovský	Yes
12	Devin Banka creditors	6	?	?
13	Milan Špak/Chemko Strážske	2	Martin Babiari	?
14	Mineral-Invod	2	Libor Jakšík	Yes
15	Yukos/Transpetrol	4	Ignác Ilčišin	?
16	Chirana-Prema	2	Michal Hrbáček, Ján Čarnogurský, others	Yes
17	Bratislava Options Exchange	6	HZDS	?
Percent who are political thugs				58.8%

Sector Key

Sector #	Sector Name	Raid?
1	Agriculture, forestry and fishing (ISIS Rev. 4 Sec. A)	X
2	Manufacturing, mining and quarrying and other industry (B, C, D, E)	X
3	Construction (F)	
4	Wholesale and retail trade, transportation and storage, accommodation and food service activities (G, H, I)	X
5	Information and communication (J)	X
6	Financial and insurance activities (K)	X
7	Real estate activities (L)	X
8	Professional, scientific, technical, administration and support service activities (M, N)	X
9	Other services (R, S, T, U)	X

Table 5.3. Energy Intensity

<u>Country</u>	<u>Energy use (kg of oil equivalent per capita)</u>	<u>Industry, value added (% of GDP)</u>	<u>Energy Intensity</u>	<u>Year</u>
Slovak Republic	4024.7	59.1	4.20158E-06	1990
Russian Federation	5351.2	43.0	4.34514E-06	1992
Ukraine	4210.4	50.9	4.66524E-06	1992
Kazakhstan	4796.1	44.6	4.67574E-06	1992
Czech Republic	4797.1	40.2	5.18415E-06	1990
Belarus	3620.7	47.8	5.78042E-06	1992
Bulgaria	3236.1	49.2	6.28127E-06	1990
Poland	2705.4	50.1	7.37646E-06	1990
Estonia	4282.7	30.4	7.68075E-06	1992
Lithuania	2978.5	42.9	7.83348E-06	1992
Slovenia	2857.6	42.4	8.24749E-06	1990
Latvia	2335.4	34.9	1.22783E-05	1992
Uzbekistan	2110.5	35.8	1.3233E-05	1992
Hungary	2419.7	31.2	1.32672E-05	1990
Croatia	1888.3	35.8	1.4813E-05	1990
Mongolia	1560.5	42.5	1.50855E-05	1990
Moldova	1845.8	31.5	1.72066E-05	1992
Macedonia, FYR	1232.8	44.5	1.82312E-05	1990
Armenia	1197.4	39.4	2.11953E-05	1992
Georgia	1776.8	23.9	2.35066E-05	1990
Kyrgyz Republic	1102.7	37.8	2.39975E-05	1992
Tajikistan	750.1	46.1	2.89458E-05	1992
Turkmenistan	2674.6	11.9	3.14539E-05	1992
Albania	540.8	42.7	4.33051E-05	1991

Source: World Bank, World Development Indicators 2013. Methodology and concept for the indicator comes from Pop-Eleches (2007), 912-13

The reason why the two countries went in such different directions in this regard was largely a matter of the choices their respective leaders made. Had Slovak policymakers realized the full ramifications of maintaining soft budget constraints – namely that it would saddle the country with a large presence of economic criminals who would undermine property rights – they may very well have made a different choice. But early Estonian governments also had little reason to understand these implications and yet hardened budget constraints anyway.

For revolutionary governments that arise through replacement, the choice to implement hard budget constraints is indeed that: a choice. Seeing that choice through requires a revolutionary government that perceives soft budget constraints as a central cause of prevailing problems and is committed to rectifying the situation whatever the costs. Both Czechoslovakia and its successor states lacked such leaders.

Table 5.4. The Degree and Speed with which Hard Budget Constraints were Instituted (1-2 years into transition)

	<u>Enterprise Restructuring</u>	<u>Price liberalization</u>	<u>Banking Reform</u>	<u>Average</u>	<u>% Difference from Estonia</u>
Estonia (1993)	3.00	4.33	3.00	3.44	
Poland (1991)	2.00	3.67	2.00	2.56	-26.6%
Slovakia (1991)	2.00	4.00	2.00	2.67	-23.3%
Ukraine (1993)	1.00	1.00	1.00	1.00	-73.4%

Source: EBRD Transition Indicators

(<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

As a result, state resources - especially soft loans and credits - continued to flow into the economy during the early 1990s (Tables 5.4 and 5.5). They largely ended up in the hands of those who had the necessary ties to key power-holders in order to obtain them. The core of the new Slovak business elite that began forming during this period coalesced from a group of ex-communists, criminal gangs, and other politically-connected businesspeople - a budding class of political thugs and crony capitalists. Thanks to soft budget constraints, such individuals were able to survive the turbulent period of the early 1990s. The wealth they derived from soft budgets likewise gave them the economic leverage to place their patrons into power. The most important of these patrons would be Vladimír Mečiar and his Movement for a Democratic Slovakia (HZDS), which would rule nearly continuously from 1992 to 1998. Thanks to these ties, they would be able to gain even greater access to soft budget constraints during Mečiar's successive governments. Soft budgets would take the form of unsupervised bank lending, the informal tunneling of state enterprises, and tax evasion scams.

As a result of the weakness of party competition, corrupt privatizations would constitute another source of soft budget constraints. Only four of the ten biggest privatizations would clearly prove to be fraudulent. However, plenty of sales beyond these ten would amount to blatant transfers into the hands of HZDS cronies. And the biggest payday by far would come from the takeovers of the Investment Privatization Funds (IPFs) in the mid-1990s, which amounted to the large-scale giveaway of recently-privatized state assets to political thugs. These highly dubious transactions took place in full public view in a country with reasonably robust democratic procedures and a vigorous free media. The only reason Mečiar and his ruling party got away with it was the relative absence of strong party competition. Had opposition parties and even the HZDS's own coalition partners been able to check its power, it is very unlikely that this large-scale asset transfer could have occurred.

The plentiful access to these and other soft budget constraints ensured that most of the plutocratic elite would be composed of either political thugs (71 to 77 percent of plutocrats) or crony capitalists (6 to 18 percent). Only 12 to 18 percent of the plutocratic elite is made up of entrepreneurs (Table 5.1). These figures are comparable to Ukraine, where political thugs comprise 53 to 65 percent of the plutocratic stratum and crony capitalists another 30 to 45 percent. By comparison, in Poland, political thugs make up 28 to 36 percent of plutocrats (28 to 41 percent are crony capitalists). In Estonia, too, the

Table 5.5. Non-Performing Loans as % of All Loans, 1991-2000

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Avg.
Estonia			7.0	3.5	2.4	2.0	2.1	4.0	2.9	1.3	3.2
Slovenia				13.8	9.3	10.1	10.0	9.5	9.3	9.3	10.2
Latvia				11.0	19.0	20.0	10.0	6.8	6.8	5.0	11.2
Hungary	11.0	21.0	29.6	20.2	12.1	9.0	6.6	7.9	4.4	3.1	12.5
Belarus				8.4	11.8	14.1	12.5	16.5	13.1	15.2	13.1
Croatia				12.2	12.9	11.2	8.2	12.6	20.6	19.8	13.9
Serbia & Montenegro				10.3	12.0	12.3	15.1	13.1	10.2	27.8	14.4
Bulgaria	40.0		6.7	6.8	12.5	15.2	13.0	11.8	17.5	10.9	14.9
Lithuania				27.0	17.3	32.2	28.3	12.5	11.9	10.8	20.0
Poland	17.0	27.0	36.4	34.0	23.9	14.7	11.5	11.8	14.9	16.8	20.8
Czech Republic	3.0	19.0	22.0	34.0	26.6	21.8	19.9	22.7	43.4	39.7	25.2
Romania	6.0	5.0	4.0	18.5	37.9	48.0	56.5	58.5	35.4	3.8	27.4
Slovakia	3.0	19.0	12.2	30.3	41.3	31.8	33.4	44.3	32.9	26.2	27.4
Moldova				31.0	36.0	45.5	26.0	32.0	29.3	20.6	31.5
Ukraine								34.6	34.2	32.5	33.8
Bosnia and Herzegovina									58.7	13.9	36.3
Albania					34.9	40.1	91.3	35.4	32.7	42.6	46.2
FYR Macedonia						66.1	59.5	50.3	62.6	46.5	57.0

*NPL levels reflect latest available data. In some cases (see references to Hungary, the Czech Republic, and Estonia below), data was not reported in the latest EBRD report. Thus, I relied on the most recently available report in which data was actually provided.

Sources: EBRD Transition Reports, 2002, 2003, 2004, 2005 (London: EBRD). Data for Hungary for 1993-96 comes from EBRD Transition Report, 2001. Data for Czech Republic for 1994 comes from EBRD Transition Report (1998). Data for Estonia and the Czech Republic for 1993 comes from Bert Scholtens (2000), "Financial regulation and financial system architecture in Central Europe," Journal of Banking & Finance 24 (525-553).

corresponding numbers are far lower than in either Slovakia or Ukraine; 26 to 32 percent of Estonia's plutocrats are political thugs and 16 to 26 percent are crony capitalists (Table 3.5).

Although other countries too saw a small handful of elites from the former regime conspire to orchestrate vast redistributions of assets, Slovakia – and particularly the takeover of the IPFs – presents an extreme example. Here, a few key individuals came up with the design, plucked from obscurity a number of young plutocrats-to-be, and tasked them with executing the plan. Not only did these political thugs likely arise from a single source, they aided and abetted each other along the way; it was indeed a case of "incestuous relations," as the chapter's beginning epigram suggests.

After accumulating wealth and power by stealing assets from the state, it was only natural for Slovakia's political thugs to begin stealing it from others through criminal corporate raiding. The ones who had already raided the IPFs would go on to undertake further raids in the ensuing years. Meanwhile, the influence wielded by political thugs

and crony capitalists allowed them to suborn successive governments (even “reformist” ones) into a web of corrupt political relationships. The extent of their power would continuously hobble any attempts to install effective property rights institutions.

The chapter will proceed as follows. The first section will detail the enormous lost opportunity on the part of early revolutionary governments to impose hard budget constraints. It will show how this failure allowed state funds and assets to flood into the hands of political thugs. The discussion below will present dozens cases studies illustrating how soft budget constraints enabled the rise of particular political thugs, many of whom went on to become raiders. We will first look at the non-plutocratic elite and then turn to its plutocratic counterpart. The final section will explore how the surplus of political thugs *and* crony capitalists – who themselves arose on the back of soft budget constraints – ended up undermining the development of effective property rights institutions.

Explaining the Rise of Slovakia’s Political Thugs

Despite the different nature of the transitions in Ukraine and Slovakia, the eventual outcome would, for the purpose of this study, essentially be the same. The reason is that early revolutionary governments in Prague and Bratislava (the Slovak capital) failed to seize the opportunity to put hard budget constraints into place. What was needed was the rapid and thorough implementation of hard budget constraints - before the incipient political thugs lurking in the background had a chance to regroup and propel their own patrons into power.

But that would not happen. Governments that came to power through elite-led change or negotiated transitions may have been bound by prevailing structural conditions - in particular continuing obligations to the ex-communist establishment - to impose hard budgets. But for revolutionaries who, like those in Prague and Bratislava, arose through the wholesale replacement of the former regime, it was mostly a matter of choice. Being relatively free of commitments to the nomenklatura, the new government had only to perceive a policy of hard budget constraints as a top priority.

But that would not be the case for post-communist leaders in Czechoslovakia, for whom the first item on the agenda was privatization, not hard budgets. Vaclav Klaus, the new Prime Minister of Czechoslovakia, was particularly obsessed with ensuring that his plan for rapid voucher privatization went through. That obsession came at the detriment of cutting firms off from soft budget constraints, above all cheap loans.⁴

The revolutionary governments that took power at the federal and republican levels after the June 1990 elections did adopt relatively tight fiscal and monetary policies and abolish most price controls. But in several key respects, they did not go the whole way in driving through a comprehensive program of hard budget constraints. To begin with, they never cleaned up the overhang of non-performing loans from the communist-era. Indeed, bad loans were not recognized by banks until much later. As a result, insolvent firms survived rather than being taken over and liquidated or restructured.⁵

⁴ Ibid., 84-89.

⁵ Ivan Mikloš, "Economic Transition and the Emergence of Clientelist Structures in Slovakia " in *Slovakia: Problems of Democratic Consolidation and the Struggle for the Rules of the Game*, ed. Soňa Szomolányi

Insolvent enterprises would serve as a major part of the foundation on which a new class of political thugs arose.

Nor did these early governments take action to shut down the insolvent state banks themselves. Instead, in 1991 the federal government simply carved out a huge portion of non-performing loans from the banks' balance sheets and placed them in a so-called "hospital bank," *Konsolidačná banka* (the Slovak portion of which became *Konsolidačná banka Bratislava* in January 1993, after the breakup). The banks were then recapitalized with newly-issued government bonds.⁶ By avoiding the refinancing of the NPLs, in which the bad loans would have been replaced by fresh ones, the creation of the hospital bank certainly did help harden budget constraints on borrowers. But it softened the budgets of the banks; instead of being shut down, as they would have been under a regime of hard budget constraints, insolvent state banks simply had their bad assets removed and replaced with good ones.

This arrangement might have succeeded had banking regulators effectively supervised lending by the banks from that point forward. But they did not. Their balance sheets restored to health, the banks were now free to engage in further risky lending. According to one specialist, "the still high levels of nonperforming loans currently held in portfolios after the recapitalization raises the question of how effective the banks have become in making new loans. Problems remain with regard to ongoing high levels of nonperforming loans, as well as...internal bank supervision, information disclosure, and general risk management."⁷ Large numbers of firms remained insolvent with non-performing loans (NPLs) extending back into the communist period. State banks continued rolling over these loans, thus enabling the insolvent firms to survive. Insolvency continued to be a problem even after the first wave of privatization began in 1992. In fact, the banks, under pressure to lend money to newly-privatized firms, did so even when such lending was not warranted on economically rational grounds. This only made the NPL problem worse.⁸

A major reason why lending to enterprises remained a risky proposition for banks was that no Slovak government in the early and mid-1990s put a workable bankruptcy mechanism into place. A functioning bankruptcy system is an essential component of the hard budget constraint; when firms cannot repay their debts they must be either restructured or, failing that, liquidated entirely. If they are instead able to continue operating, they enjoy what amounts to soft financing from their creditors on an indefinite basis. Yet, even as late as 1997, 50 percent of Slovakia's enterprises remained effectively insolvent. As of that time, according to Ivan Mikloš, "[t]he government, operating through tax offices, the state budget, insurance funds, and state-owned enterprises, is Slovakia's largest creditor." "State-owned banks," he continued,

and John A. Gould (New York and Bratislava: Columbia International Affairs Online & Slovak Political Science Association/Friedrich Ebert Stiftung, 1997).

⁶ Michael S. Borish, Wei Ding, and Michel Noël, "Restructuring the State-Owned Banking Sector: A Comparative Assessment of Approaches in Central Europe," *MOST: Economic Policy in Transitional Economies* 7, no. 1 (1997): 58-60; Michael Marrese, "Addressing the Bad Debt Problem in the Slovak Economy," in *Emerging Financial Markets in the Global Economy*, ed. Larry Sawers, Daniel Schydrowsky, and David Nickerso (Singapore: World Scientific, 2000), 201-07.

⁷ Borish et al., "Restructuring the State-Owned Banking Sector: A Comparative Assessment of Approaches in Central Europe."

⁸ Martin Berka, "Restructuring the Banking Sector in Slovakia" (Central European University, 1998).

“constitute another major creditor group. Debtors are primarily represented by enterprises, most of them privatized.”⁹ In 1994, Deputy Prime Minister Brigita Schmögnerová noted that “the fact that weak companies have not failed yet reflects the position of their creditors, i.e. banks. It reveals [the] unsuitable structure of their capital and loan portfolio: by forcing defaulting companies into liquidation the banks would get into trouble as well.”¹⁰ The lack of effective supervision of banks also enabled unscrupulous operators to set up new private banks, supported by the big state banks (namely SLSP), for the sole purpose of tunneling them.¹¹

The upshot of all of this was that, well into the 1990s, neither banks nor the firms they lent to faced adequately hard budget constraints. As banks and their debtors were able to survive, so were the individuals who controlled them. Many of them formed a budding class of political thugs. They found a political ally in Vladimír Mečiar, the Prime Minister of Slovakia. According to Mikloš, “[o]ld structures supported Vladimír Mečiar as early as 1991 when he was in the opposition.”¹² This was thanks in part to his staunch opposition to voucher privatization and the Lustration Law, which had seen many former communists purged from their positions as ministers, union leaders, and enterprise managers.¹³ To make matters worse in their eyes, the government, led by the strongly anticommunist Public Against Violence (VPN), also cut subsidies to state enterprises. This might not have posed a major problem for reformers had the inefficient state firms that were host to these incipient political thugs been allowed to fail. But they were not; while subsidies may have been greatly reduced, state banks, as we saw above, continued to lend on easy terms to state-owned enterprises.

As a result, the very managers who had become so embittered by the reforms were able to survive and form a powerful base of support behind Mečiar. In March 1991, Mečiar broke away from VPN on the grounds that its economic reform program was too radical. Now in opposition, he aligned with the Federation of Employers Unions and Associations (AZZZ), which represented ex-communist managers, bureaucrats, and former local party chiefs. He also established a new political party, the HZDS, which was able to count the AZZZ as its most powerful supporter.¹⁴

With Mečiar and his allies out of the way, the Slovak government, now under Ján Čarnogurský (Prime Minister from April 1991 to June 1992), arguably had another opportunity to impose hard budget constraints. But they did not do so. A program of hard budget constraints is most likely to succeed if implemented quickly by a newly-elected government while it still enjoys mass public support. But the Čarnogurský government came to power through backroom parliamentary maneuvering, not a national election. And by the point it did so, almost a year and a half had passed since the Velvet Revolution and the euphoria that had accompanied it had dissipated. The initial post-communist government that assumed power in June 1990 may have had enough popular support to push through sweeping hard budget constraints. But this was no longer the case by the time Čarnogurský took office.

⁹ Mikloš.

¹⁰ M.E.S.A. 10, *Promises and Reality - Slovak Economy 1995-1998* (Bratislava: M.E.S.A. 10 - Center for Economic and Social Analyses, 1998), 146.

¹¹ Berka.

¹² Mikloš.

¹³ Gould, 68-69.

¹⁴ *Ibid.*, 76-79.

Moreover, ex-communist enterprise managers, having averted hard budget constraints from the beginning, could now regroup and place key patrons into government posts. It had such patrons in Ján Holčík, the Minister of Industry, and Jozef Bezák, Minister of Economy, who maintained a conservative industrial policy. Both had ties to state-owned enterprises and were determined to maintain state support for these firms until they could be restructured. Even so, hard budget constraints were not the main priority of the new government, which was committed above all else to seeing voucher privatization through to completion.¹⁵

In any event, Čarnogurský's time in office would be short-lived. Having survived the long winter of the early 1990s thanks to soft budget constraints, the incipient class of political thugs centered around the AZZZ managed to bring their patrons in the HZDS back to power - first in 1992 and again in 1994. Once back at the helm, Mečiar would make it his business to advance the cause of these corrupt economic interests. Upon the start of his second premiership after his party's victory in the June 1992 elections, he ended lustration and reappointed lustrated members of the former nomenklatura to their old positions at state enterprises.¹⁶ He also greatly expanded the scope of soft budget constraints, in the process lining their pockets as well as his own. This is a perfect example of the feedback effects between soft budget constraints and the rise of political thugs; once they have begun to grow in wealth as a result of soft budgets, political thugs acquire increased political influence to bring about still wider and deeper soft budget constraints.

One of the primary forms soft budget constraints took was the stripping of assets from state enterprises through "spontaneous privatizations." Because these transactions involve selling inputs to the enterprises at artificially high prices and/or buying the outputs at artificially low prices, they amount to soft budget constraints on the beneficiaries. Many industrial managers who supported Mečiar were involved in these schemes. Beginning in the early post-communist period, they employed input-output schemes to shift assets from the state firms they ran to private entities they controlled.¹⁷ These represented soft budget constraints just as much as legal subsidies did, as they typically took the form of insider-controlled private firms buying low from, or selling high to, state companies. In addition, from 1992, the second Mečiar government appointed its allies to the management of a number of key state companies. Their main priority was to tunnel assets from these firms into the hands of insiders through the bankruptcy process. Although, as noted above, Slovakia still lacked a functioning bankruptcy mechanism, when it came to the task of tunneling state enterprises Mečiar and his allies made sure it worked.¹⁸ Big state banks such as VÚB and IRB were themselves the subjects such looting; allegedly, the HZDS-appointees who managed them regularly funneled bank funds into the party's coffers.¹⁹

Officials around the Slovak Information Service (SIS), the successor to the ŠtB, the communist-era intelligence agency, were reportedly engaged in the illegal sale of state arms. This too must be seen as a soft budget constraint, as the weapons could be

¹⁵ Ibid., 105-06.

¹⁶ Ibid., 108.

¹⁷ Mikloš.

¹⁸ Interview with Respondent #42

¹⁹ Interviews with Respondents #36 and #38

obtained on easy terms from the SIS for subsequent sale. To quote Tom Nicholson, one of Slovakia's top investigative journalists, "The cynicism [in the SIS] goes so deep that at the same time the SIS secret service was rejecting reports it was involved in the illegal arms trade, a former senior SIS officer, Anton Rázga, was chairman of the board of the arms firm Magic Trading Corporation, while former SIS director Vladimír Mitro became the defence attorney for arms trader Ašot Mkrtyčev, who this week was convicted of murder."²⁰ The central actor in the theft of weapons from the intelligence agency, according to an internal report, was SIS agent Michal Hrbáček, a political thug of the first order about whom we will have much more to say later on.²¹ Meanwhile, Slovenská Poistovňa (SP), the state insurer, awarded a contract to a firm under the SIS's control to provide security on its premises.²²

Of the various informal means used to siphon state assets through soft budget constraints, by far the biggest was the heating oil scam. This involved importing gasoline while declaring it as light heating oil, which is taxed at a much lower rate. In the end it was estimated to have generated hundreds of billions of crowns for the actors involved. Nicholson confirms its importance: "The principal source of mafia money in this country," he asserts, "has been oil fraud." It essentially amounted to a tax break that enabled a massive flow of state money into the hands of political thugs. Most of its beneficiaries had begun their careers in far less lucrative criminal enterprises such as protection rackets but would strike it rich in the heating-oil fraud. It was not only the Mečiar governments that were complicit in this; the scam began as early as 1990 and went on for the next 15 years, well after the HZDS lost power in 1998. A long-running investigation launched in 2004 resulted in dozens of arrests. "But it was the same thing, you know," says Nicholson, "82 people arrested and jailed but they were let out by the courts."²³

"White horses" – that is, persons not formally connected to the party but who actually represented prominent HZDS figures – were appointed to manage firms that received the VAT refunds from the state.²⁴ Later on, many of them ended up murdered to protect the identities of the real beneficiaries of such schemes; in the notorious "acid bath" case, a Bratislava gang organized hits on white horses and then dissolved the bodies in vats of acid.²⁵

Among the central figures in the scheme were two sitting SIS officers, Jozef Oleš (now in an Austrian prison for drug trafficking) and Vladimír Stýče.²⁶ Also thought to play a pivotal role was Libuše Martinčková, a parliamentary deputy from the allegedly "pro-reform" Slovak Democratic and Christian Union (SDKÚ), the main party in the coalition that replaced the HZDS in 1998. She had her parliamentary immunity revoked to allow an investigation into her alleged involvement to proceed.²⁷ Prominent organized crime figures such as Ondrej Žemba, Ivan Kmotřík (one of our plutocrats), and Peter

²⁰ Tom Nicholson, "Civilian oversight of police needed (editorial)." *Slovak Spectator*, April 30-May 6.

²¹ Tom Nicholson, "Pride came before the fall," *Slovak Spectator*, 20 October 2008

²² "Dinič brothers terrorized Bratislava businessmen," *Slovak Spectator*, 20 October 1998

²³ Interview with Tom Nicholson, 9 October 2007

²⁴ Interview with Respondent #42

²⁵ Interview with Respondent #42; "More acid bath murderers detained in Slovakia." *CTK Daily News*, June 27, 2002.

²⁶ Interview and communications with with Respondent #55, 2007 and 2014.

²⁷ "Another man involved in light mineral oils scandal shot dead." *CTK Daily News*, December 22, 2006.

Čongrády also benefited from the frauds.²⁸ Considering the stakes were so high, the oil scam “accounts for the conflicts [that organized crime groups] had with each other over the years as people got closer or further away from the trade.”²⁹

To sum up thus far, because Slovakia’s early reformist governments failed to rein in soft loans, incipient political thugs were able to survive and return Mečiar to power. Under his rule they managed to greatly expand the scope of soft budget constraints to include informal tunneling from state enterprises as well as tax fraud.

They also gained access to another form of soft budget constraint: the fraudulent privatization of state companies for pennies on the dollar, often using loans provided by the state itself. The high incidence of privatization fraud led to a proliferation of political thugs not only among the non-plutocratic elite but the plutocrats as well.

If one were to examine the ten largest privatizations alone, one might conclude that the level of corruption in the privatization process was relatively mild compared to Ukraine; only four of these sales were marked by signs of serious fraud. As with Ukraine, I examined the top-ten Slovak privatizations ranked by revenues the year prior to the privatization multiplied by the percentage of the stake sold. The following discussion will consider each of these sales in order from largest to smallest.

The biggest privatization in the history of post-communist Slovakia was the February 2005 sale of 66 percent of Slovenské elektrárne (SE) to Italy’s Enel. This was one of the four cases where indications of serious fraud were present. It occurred during the second government of Mikuláš Dzurinda. Because SE controlled 85 percent of the domestic electricity market, the privatization attracted interest from a number of (mostly foreign) companies. On the face of it, the sale appeared fair. It took place in two rounds and, in the end, Enel offered the highest price among the three companies that submitted bids. Later, however, an investigation by the newspaper *Pravda* alleged that Enel’s victory had in fact been determined in advance. According to the article, it was Economy Minister Pavol Rusko who pushed for the holding of a second round because, in the first round, the highest price had been offered not by Enel but by another bidder; a second round would give Enel another chance. This time, moreover, Enel was allegedly given privileged access to information regarding how to structure its offer in line with the government’s preferences. In particular, the newspaper reported, Enel was advised to remove certain conditions from its original offer that the state could not fulfill, thereby clearing the way for the state to accept Enel’s bid. In 2011, leaked transcripts from a wiretap operation by the SIS (the so-called Gorila file) supported the earlier claims of political interference in the SE privatization. The transcripts reveal key business figures discussing how members of SE’s management took steps to deliberately reduce the company’s value in the run-up to the privatization.³⁰

The second place on the list belongs to Slovenský Plynárenský Priemysel (SPP), the country’s main natural gas supplier. In March 2002, the government sold a 49 percent stake in SPP. This was the second of four sales that were clearly fraudulent. It

²⁸ Interviews with Respondents #47 and #55

²⁹ Interview with Tom Nicholson

³⁰ “ČEZ na Slovensku neuspel vyššia cena by už bola podľa jeho vedenia nadnesená,” *SME*, 13 September 2004; “Privatizácia SE: V Londýne sa analyzuje, v Bratislave lobuje,” *Trend*, 4 August 2004; “Chronológia privatizácie Slovenských elektrární a VE Gabčíkovo,” *www.teraz.sk*, 15 June 2013; “Hodnotenie: Koniec Ruska začal Hankook,” *Pravda*, 24 May 2006; “Polícia vidí v privatizácii elektrární trestný čin,” *Pravda*, 6 March 2013.

too occurred under the ostensibly reformist government of Dzurinda which would later oversee the country's accession to the European Union. A number of foreign companies expressed interest in the privatization. In the end, only one – a consortium of Gaz de France, Ruhrgas, and Gazprom – chose to make an offer. Its bid of \$2.7 billion fell below the \$3-4 billion that analysts had previously estimated as the company's true value. A 2007 report by the government of Prime Minister Róbert Fico raised serious questions about how the privatization of SPP occurred. In addition to alleged corruption in the process of choosing the privatization adviser, it pointed out that the valuation on which the Dzurinda government had based its decision had not been carried out through the proper channels. It rather relied on an audit firm that made what appeared to be an artificially low estimate of \$1.82-2.35 billion. The sale was also non-transparent, which for our purposes counts as a sufficient indicator of fraud. Important documents specifying the conditions for selecting a strategic investor turned up missing, as did notarized copies of the opening offers. Information also emerged suggesting that the consortium probably knew in advance that they were entering the tender without any competition, something which might have caused them to submit a lower bid. Also, the resulting shareholders agreement contained stipulations preventing the National Property Fund (FNM) from exercising certain rights as a majority shareholder.³¹

In contrast to the sales of SE and SPP, the January 2001 privatization of Slovenská sporiteľňa (SLSP), Slovakia's largest bank, occurred transparently and without any signs of corruption. Austria's Erste Bank emerged as the winner of an 87.18 percent stake, beating out two rival bids. It paid €425 million for the shares, or 1.78 times book value. It also agreed to invest SKK 6.5 billion into SLSP over the ensuing five years. Following the sale, Erste Bank sold 19.9 percent of the bank to the European Bank for Reconstruction and Development.³²

Like SLSP, the July 2001 sale of Všeobecná úverová banka was similarly regarded as honest and transparent. Banca Commerciale Italiana won the competition by making an offer that exceeded that of France's Société Générale by approximately 20 percent.³³ The privatization of state insurer Slovenská poisťovňa (SP) in February 2002 also occurred without serious incident. Eight investors submitted non-binding offers. Of these, two decided to participate in the final tender. Germany's Allianz made the winning bid for 57 percent of SP. A 2002 report by INEKO, the non-governmental watchdog, gave the sale its stamp of approval.³⁴

The same could not be said of the 1995 privatization of 39 percent of Slovnaft, the oil refinery, to Slovintegra, which was controlled by Slovnaft's own director, Slavomír

³¹ INEKO, *Hodnotenie Ekonomických a Sociálnych Opatrení 2002* (Bratislava: Institute for Social and Economic Reforms (INEKO), 2003).; "Správa o procese privatizácie SPP," Národná rada Slovenskej republiky, 2007.

³² "Predali šesť bánk, jednu poisťovňu," *SME*, 22. August 2002; "Predaj sporiteľne je hodnotený najvyššie," *SME*, 19. January 2001; Konečná cena za SLSP je oproti pôvodne dohodnutej nižšia o 589 miliónov Sk," *SME*, 20 December 2001; "Ponuku na kúpu SLSP predložili traja záujemcovia," *Profíni.sk*, 4. December 2000; "Prehľad najdôležitejších domácich udalostí v ekonomike za rok 2000," *SME*, 1. January 2001; Profil banky," *slsp.sk*. INEKO, *Hodnotenie Ekonomických a Sociálnych Opatrení Apríl 2000 - December 2001* (Bratislava: INEKO).

³³ "Talianska IntesaBci ponúkla za VÚB viac," *SME*, 16 June 2001; "Zástupcovia štátu a banky IntesaBci podpísali predaj VÚB," *Profíni.sk*, 6 July 2001.

³⁴ INEKO, *Hodnotenie Ekonomických a Sociálnych Opatrení 2002*. "Nemci vyhrali súťaž o Slovenskú poisťovňu," *SME*, 21 December 2001.

Hatina. The sale occurred during the third Mečiar government (1994-98) and without any public competition. Hatina was known to be a close ally of Mečiar. In a series of privatizations, including this one, Hatina was able to gain a majority of Slovnaft at a fraction of its estimated value. The SKK 6.5 billion offer made by Slovintegra in the August 1995 sale corresponded exactly to the company's stock market value at the time. However, various provisions in the contract allowed Slovintegra to get away with paying a mere SKK 1 billion. Some of these special provisions set new standards for absurdity, such as one promising a discount to *Slovintegra* (the buyer) in the event that *Slovnaft* invested a certain amount in its own production capacity over the next few years. Typically, it is the buyer who agrees to the investment obligations in return for a discount. In this instance, it was the state company itself that promised to make the investment. Why Slovintegra should have been given a discount for investments to be paid for by Slovnaft will forever remain a mystery.³⁵

In contrast to the 1995 privatization of Slovnaft, the June 2002 sale of 49 percent of Západoslovenská energetika (ZSE), Slovakia's leading energy company, was seen as fair. E.ON Energie, the German energy group, submitted the winning bid, even though unofficial sources noted it was slightly less than a rival offer made by Austria's EVN. However, this was justified on the grounds that E.ON had a much stronger financial position than EVN; EVN was valued at less than ZSE, the very company it was seeking to purchase. INEKO, the NGO watchdog, evaluated the privatization favorably.³⁶

The June 2002 privatization of Stredoslovenská energetika (SSE) was likewise regarded as transparent and honest at the time. France's EDF, clearly the superior bidder, won out over Italy's E-Noti for the 49 percent stake. Once again, INEKO rated the sale positively. Concerns were voiced in 2013 when EDF sold its part of the firm for over four times what it had paid initially. But these criticisms were mitigated by the fact that the 2002 privatization was genuinely competitive and no prospective buyer at the time was willing to pay anywhere near the amount for which EDF would eventually sell its stake.³⁷

The July 2000 privatization of telecoms company Slovenské Telekomunikácie was marred by a scandal over the selection process for the privatization adviser. But the sale itself did not give rise to any overt indications of fraud. All but one of the interested parties, Deutsche Telecom, withdrew from the process over complaints that the

³⁵ M.E.S.A. 10, *Od Spoločného k Súkromnému. 10 Rokov Privatizácie na Slovensku* (Bratislava: M.E.S.A. 10, 1999). "Slovintegra zaplatila za akcie Slovnaftu 1,38 mld Sk, nešlo však o peniaze majiteľov Slovintegry," *SME*, 6 March 1999; "Fond národného majetku SR na privatizácii jednoznačne prerábala," *Trend*, 11 March 1998; "Vedenie Slovnaftu sa ohradzuje proti výrokom V. Palka o privatizácii podniku," *SME*, 22 February 1996; "Mečiar predával lacno, za SPP chce viac," *Pravda*, 7 February 20; "Podľa Hatinu Slovnaft nikto nechcel kúpiť," *SME*, 30 March 2004; "RETRO: Slovnaft sprivatizovala firma Slovintegra" *HN online*, 16 August 2005; "Slovnaft sa privatizuje už šesť rokov," *Trend*, 26 May 1999.

³⁶ Profil ZSE," *skupinazse.sk*, 2013; "Pre EVN sa privatizácia ešte neskončila," *HN online*, 23. April 2002; "Hodnotenie ekonomických a sociálnych opatrení 2002," *INEKO, May 2003*; "Vítazom tendra by mal byť najsilnejší," *HN online*, 15. May 2002

³⁷ "Francúzi zarobili na privatizácii pol miliardy," *Pravda*, 26. May 2013; "Záujemcovia o slovenské distribučky finišujú s prípravou ponúk," *Trend*, 8 April 2002; "Vláda definitívne schválila predaj podielov v distribučných podnikoch," *Trend*, 23. May 2002; "Komisia odporučila za víťaza tendra na 49 % akcií SSE francúzsky EdF," *SME*, 24. April 2002; "Vláda definitívne schválila predaj podielov v distribučných podnikoch," *Trend*, 23. May 2002; "Hodnotenie ekonomických a sociálnych opatrení 2002." INEKO, *Hodnotenie Ekonomických a Sociálnych Opatrení 2002*.

government was constantly changing the sale terms. This fact raised some questions but was not sufficient to suggest that the sale was corrupt.³⁸

However, the final privatization on the list – that of 51 percent of gasoline company Benzinol in April 1995 – was a different matter entirely. Like the sale of Slovnaft, it occurred during the third Mečiar government. And like the sale of Slovnaft, the company was sold to the Slovnaft management under Slavomír Hatina, which paid a nominal sum for Benzinol in a direct sale without any public competition. The purchase of Benzinol gave Slovnaft control over approximately 85 percent of the domestic retail fuel market. When the Antimonopoly Office objected to the privatization on these grounds, its head, Zdenek Kováč, was dismissed, ostensibly due to exhaustion. The supposed exhaustion Kováč was suffering was apparently news to Kováč himself, who claimed to be feeling fine. Once he was out of the way, the sale proceeded smoothly.³⁹

The fact that only four of the ten biggest privatizations were overtly corrupt might lead one to believe that the process was not as bad as in Ukraine, where serious corruption characterized eight – if not nine – of the top-ten sales. This perception is dispelled once we take a step back and look at the broader picture. In the 1990s, successive HZDS-led governments under Mečiar engineered a privatization process marked by extreme and overt fraud. While only two of these privatizations made the top-ten rankings, a number of others, including sales of the VSŽ steel plant and the SCP Ružomberok paper mill, occupy positions in the next ten. And there were plenty of others further down the list that contributed the growing fortunes of Slovakia's political thugs and crony capitalists.

The fraudulent privatizations began in 1992 under Mečiar's second premiership. To run the privatization program, Mečiar appointed his close ally, Ivan Lexa. Lexa's first decision as state secretary of the Ministry of Privatization was to sell Považské mlyny a cestovinárne, a.s. to his own father.⁴⁰ Such privatizations would become the norm under Mečiar's second government, which would last until early 1994. By February 1994, Mečiar's political future was in peril as dissatisfied members of his coalition were pushing for a vote of no-confidence in his government. Faced with this imminent threat to his survival, Mečiar tried to change their minds by privatizing state companies to relatives of anyone who seemed to be wavering in their support. Fire sales of state enterprises began during the last month, and particularly the last day, of Mečiar's second premiership.⁴¹ In the 28 days before he was ousted, Mečiar and Lexa privatized 44 companies, having a book value of \$96 million, for a total of \$22 million.⁴² Among the sales was a 9.5 percent stake in steelmaker VSZ to a company called, simply, "Manager,"

³⁸ "Privatizácia Slovenských telekomunikácií – chronológia," *Profini.sk*, 5. July 2000; "Hodnotenie ekonomických a sociálnych opatrení apríl 2000 - december 2001," Privatizácia Slovenských telekomunikácií – chronológia," *Profini.sk*, 5. July 2000. INEKO, *Hodnotenie Ekonomických a Sociálnych Opatrení Apríl 2000 - December 2001*.

³⁹ "RETRO: Slovnaft sprivatizovala firma Slovintegra," *HN online*, 16 August 2005; "RETRO: Slovnaft získal Benzinol a posilnil svoj monopol," *HN online*, 22 March 2005; "Dominanciu Slovnaftu odštartoval predaj Benzinol," *Obroda*, 25 February 2005; "Protimonopolný úrad SR schválil koncentráciu Slovnaftu s Benzinolom," *SME*, 26 May 1995.

⁴⁰ Gould, 109.

⁴¹ Chandler Rosenberger, "Big Brother in a Small Country: The Subversion of the Rule of Law in Contemporary Slovakia," *Human Rights Review* 1, no. 1 (1999): 37-38. On privatizations under Mečiar's second government, see Gould, 108-11.

⁴² Gould, 110.

which was set up by members of the company's advisory board. The stake was sold for \$36m less than its stock market value.⁴³

Also sold off was 67 percent of the profitable glass maker Skloobal for a fraction of its value, along with a 50 percent stake in the Piešťany spa to a company controlled by health minister Viliam Soboňa.⁴⁴ So Soboňa did not have to put up any cash himself; the money for the privatization came from a loan from a state bank backed by the spa itself as collateral. In essence, the state gave away the company to Soboňa, letting him keep any profits he subsequently generated while gladly promising to take it off his hands in the event he instead decided to run it into the ground. (After Dzurinda's SDKÚ took power in 1998, the National Property Fund tried to cancel the contract, but Soboňa appealed to the High Court, where he had a friend in judge Jozef Štefanko, who received free treatment at Soboňa's spas.)⁴⁵ Majority control in two locomotive repair companies went to the wife of Vít'azoslav Moric, a deputy from the Slovak National Party, while Moric himself secured an appointment as manager of a state arms export firm. The wife of HZDS deputy Milos Vajda received Novo Frucht, a food processor. "Other HZDS deputies were appointed to the plainly superfluous, but potentially lucrative, posts of 'advisor to the privatization minister' - Mečiar himself."⁴⁶

Despite these last-minute efforts to shore up his support, the no-confidence vote in Mečiar's government succeeded and by March 1994 he found himself out of power once again. He was replaced by a new and more reformist coalition under Jozef Moravčík pending elections later that year. However, the HZDS ended up winning those elections and returning to power, in a coalition with the extreme right Slovak National Party and the extreme left Association of Slovak Workers, before the year was out.⁴⁷

The third Mečiar government would continue the openly fraudulent privatization of state companies. Not content to privatize only those enterprises that had not already been sold, the new coalition sought to reverse the privatizations completed by the previous government. When the newly-elected parliament convened on the night of November 4, 1994, the new Mečiar government pushed through a law invalidating all of the 50-odd privatizations that had been completed under the Moravčík government. In May 1995, the Constitutional Court ruled that this move violated the constitution, as it contravened the constitutional division of powers as well as the property rights of the new owners. However, the government promptly responded that the decision had no legal force and would therefore ignore it.⁴⁸

Now in power for the third time, Mečiar and his allies went to great lengths to ensure that the privatization process would involve as little transparency and external control as possible. To do so, they transferred authority to decide on privatizations from the government to the far less accountable National Property Fund (FNM).⁴⁹ They

⁴³ Neil King Jr., "Ex-Slovak Regime Said to Have Sold Assets at a Discount." *The Wall Street Journal* (Europe edition), March 21, 1994

⁴⁴ Ibid.

⁴⁵ "Corruption rife in Slovak courts - Nepszabadsag." *CTK Business News*, August 15, 2000.

⁴⁶ Rosenberger, "Big Brother in a Small Country: The Subversion of the Rule of Law in Contemporary Slovakia," 37-38.

⁴⁷ Gould, 114.

⁴⁸ Emily Church, "Slovak markets remain calm amid political storm." *Reuters News*, November 4, 1994; "Constitutional court ruling has no practical effect – Mečiar," *CTK Business News*, May 29, 1995.

⁴⁹ "Parliament passes two privatisation laws," *CTK Business News*, December 22, 1994.

simultaneously purged that body, replacing 16 of its top officials with party loyalists.⁵⁰ Henceforth, opposition parties would have no representatives inside the FNM, which was itself formally removed from the state administration to avoid any requirements for audits or public disclosure of information relating to the sales.⁵¹

With such an unaccountable structure in place, it would come as no surprise that the state firms to be privatized in the new round would be sold for a song. According to one report, between 1995 and 1998 the FNM sold assets with a book value of Sk109.2 billion for only Sk30.7 billion, a mere 28 percent of their actual worth.⁵² The formal buyers this time around were often white horses. The real owners, of course, were powerful figures around the ruling coalition. The system of payments was disorganized, to say the least. "Putting money from privatization into the state budget is too complicated. It was easier to just put the money into the HZDS's coffers," noted one of my sources.⁵³

If the prices the buyers paid were shockingly low, they did not even have to come up with the modest funds themselves; state banks controlled by the HZDS were happy to lend it to them. The money to finance the purchases usually came from one of the big state-run banks such as IRB and, especially, VÚB. Loaning money from the state to buy state companies appeared to defeat the main purpose of privatization, which typically is to raise revenue for the state. But that did not seem to bother the government, for whom revenue-raising could not be further from the real agenda, which was to put wealth into the hands of party cronies. According to one source, "If somebody among the top-level decision makers in the party wanted to privatize a plant somewhere...he just came to VÚB and asked for it. The only collateral was one's party ID card." In all, VÚB extended loans to HZDS figures totaling Sk60-90 billion - which amounted to 50-75 percent of the bank's total capitalization at the time.⁵⁴ In this way, soft budget constraints in the form of underpriced privatizations were compounded and enabled by additional soft budget constraints in the form of soft loans to the buyers.

Consider some of the more notable examples. In addition to Slovnaft and SPP, which were sold to Mečiar ally Slavomír Hatina (discussed above), in July 1995 the government sold 15% of VSZ to a company that had been formed only a few weeks earlier. The sale price amounted to half of what the VSZ was trading for on the stock exchange.⁵⁵ Another HZDS loyalist, Karol Martinka, purchased a spa at the same time that his wife was an advisor to Mečiar. After Mečiar's ouster in 1998, the pair had to flee to Austria to avoid charges of fraud related to the spa's privatization.⁵⁶ An eight-year campaign by prosecutors to bring them to justice ensued but was finally called off in June 2006 just after the HZDS returned to power as part of a new coalition.⁵⁷

⁵⁰ "Slovak state fund withdraws shares for second time," *Reuters News*, November 7, 1994.

⁵¹ Mikloš.

⁵² "Slovak govt unable to cope with inherited privatisation scandals." *CTK Business News*, September 27, 1999.

⁵³ Interview with Respondent #36

⁵⁴ Interview with Respondent #38

⁵⁵ Neil King Jr., "Mečiar Mounts Hostile Bid for Slovakia." *The Wall Street Journal*, September 20, 1995

⁵⁶ "Slovak businessman facing fraud charges to seek amnesty," *BBC Monitoring European*, September 11, 2001.

⁵⁷ "Mečiar Believes Ex-Spy Boss Ivan Lexa Deserves Rehabilitation," *SITA*, July 3, 2006.

The HZDS was rather shameless about who they allowed to benefit from the privatization process. In particular, a number of state companies were sold to ordinary thugs from the world of organized crime. Róbert Holub, a prominent mob boss in the eastern city of Košice, was the beneficiary of several privatizations of food producers before he was shot dead in 1999.⁵⁸ Others, such as Peter Steinhubel, Miroslav Sýkora, Mikuláš Černák, Jozef Svoboda, and Ondrej Žemba also participated in privatizations.⁵⁹ Steinhubel, to quote one source, is the “case par excellence” of an underworld figure who successfully moved from conventional criminal rackets into more legitimate businesses. Before his murder in 1999, he had built a small business empire spanning casinos, restaurants, and night clubs as well as storage facilities that won contracts with the state to store its energy reserves.⁶⁰

Senior HZDS figures were perfectly comfortable speaking openly about their involvement in privatization fraud. Štefan Gavornik, Chairman of the FNM, admitted publicly that certain high-level politicians were among the new owners, although he refused to name them. He did note that if he ever decided to write his memoirs he would not live long enough to finish the first chapter. Víťazoslav Móric, a leader of the Slovak National Party, a coalition member, was a bit more blunt: “fair privatization does not exist; we all know that the only criterion is loyalty... The winner takes everything.” He was one to know, as his own wife benefited from the privatizations. Ján Ducky, the Economy Minister, asserted that privatizing state companies to insiders is perfectly natural; “each government in the world gives to those who cooperate with it.”⁶¹

Every developing country seems to have its own “Mr. Five Percent” or “Mr. Ten Percent,” a particularly graft-prone public official so named for the amount of the bribe he typically demands. Slovakia had a “Mr. Twenty” in Ducky, as he would insist on a kickback of either 20 percent or 20 million in any privatization deal.⁶² Aside from demanding payoffs, Ducky, a former member of the nomenklatura, also engaged in the systematic looting of SPP, the state gas company. Given his involvement in extortion, his deep knowledge of Slovak corruption, and his reported fondness for both talking and drinking, Ducky was assassinated in January 1999, not long after a new coalition under Dzurinda took power.⁶³

While important in financing the rise of myriad political thugs, the fraudulent privatizations noted above paled in importance when compared to the Mečiar-backed takeovers of the Investment Privatization Funds (IPFs). These will be described in much greater detail in a later section. Suffice to say, these acquisitions, more than anything else, were responsible for creating the fortunes of most of the political thugs on our list of plutocrats. On the one hand, they were not technically “privatizations” in the strict sense of the word given that the IPFs were already private; they had been set up several years earlier to participate in the voucher privatization process. On the other hand, the IPF takeovers are properly seen as the end-result of the Slovak privatization process; the

⁵⁸ “Košice Underworld Boss Shooting Investigated,” *Tlacova Agentúra Slovenskej Republiky*, December 16, 1999.

⁵⁹ Interview with source

⁶⁰ Interview with Respondent #43

⁶¹ Mikloš.

⁶² Interview with Respondent #55; Interview with Respondent #38

⁶³ Interview with Respondent #38

funds merely acted as temporary holding entities for recently-privatized state assets on their way into the hands of their final owners.

The takeovers of the IPFs were very much backed by the HZDS-led governments. They also occurred in full public view. Only nobody was strong enough to stop them. Indeed, what allowed for them to take place was the same thing that enabled the massive corruption that beset the privatization process in general: the weak nature of party competition. Early on in the post-communist transition, the greatest likelihood for hard budget constraints existed where there was an *imbalance* of power in favor of revolutionaries. This condition obtained in both Slovakia and Estonia. However, in order to constrain blatant privatization fraud, that initial imbalance must be followed by a rebalancing of power among political parties.

Slovakia was distinct from Estonia in the consistent absence of a strong and vigorous parliamentary opposition. Slovakia scores even worse than Ukraine on our first dimension of party-competition robustness, the extent to which the opposition is critical of the government. This is measured by the number of questions asked per MP; in Slovakia, parliamentary deputies asked an average of only 0.94 questions per year, compared with 1.22 for Ukraine. The strength of Slovak party competition in this regard appears even lower when viewed in light of Estonia and Poland, where deputies asked 3.54 and 3.78 questions per year, respectively (Table 5.6).

In addition to not being critical, a higher number of Slovak parties were excluded from consideration by all other parties in negotiations over the formation of coalitions. This rendered the parties less *plausible* and was evident in the much smaller percentage of Slovak deputies belonging to ostracized parties (Table 5.6). The ethnic Hungarian parties were shunned by all. In addition, the HZDS' two coalition partners from 1994 to 1998 – the Association of Slovak Workers (ZRS) and the SNS – were sufficiently extremist as to render them outcasts from consideration by other potential coalition partners. This made them all the more dependent on the HZDS, the senior member of the coalition, reducing any tendency they might have had to try and rein in its excesses. This left only two parties – the Christian Democratic Movement (KDH) and the Freedom Union (US) – as the only two opposition parties that could potentially restrain the HZDS. But the KDH was unable to fulfill this role due to infighting.⁶⁴

Aside from low criticism and plausibility, party competition in Slovakia also suffered from the relative inability of opposition parties to *credibly threaten* governments with removal in national elections. The longest-serving Slovak government during the main era of privatization (1990-2006) stayed in power almost twice as long as the longest-serving Polish and Estonian governments (Table 5.6).

From the very start of the post-communist period, Slovakia lacked the kind of threatening parliamentary opposition that would come to characterize the political systems of Poland and Estonia. When the first two Mečiar governments fell from power in 1991 and 1994, respectively, this was the result of internal coalition defections rather than a vigorous opposition. From 1992 to 1998, Mečiar and the HZDS won successive elections and remained in power virtually continuously. “Repeatedly reelected into office and left to formulate the terms of the political debate,” Grzymała-Busse writes of both the HZDS and the Czech ruling party in this period “they acted much like dominant parties,

⁶⁴ Grzymała-Busse, 76.

Table 5.6. Party Competition Indicators

<u>Questions per MP*</u>		<u>Questions per MP in Ukraine (by Year)</u>		<u>Longest Tenure of Ruling Party in Office During Main Era of Privatization</u>		
<u>Questions per MP (by Country)</u>				<u>Country</u>	<u>Longest Tenure (months)</u>	<u>Dates</u>
Estonia	3.54	1998	0.40	Estonia	48	Mar. 1995 to Mar. 1999
Poland	3.78	1999	0.93	Poland	48	Oct. 1997 to Oct. 2001
Slovakia	0.94	2000	0.65	Slovakia	92	Nov. 1998 to July 2006
Ukraine	1.22	2001	0.73			
		2002	0.54			
		2003	2.08			
		2004	2.51			
		2005	4.13			
		2006	0.94			
		2007	0.08			
		2008	0.38			
		2009	0.92			
		2010	0.67			
		2011	1.43			
		2012	1.18			
		2013	1.93			
		<u>Average</u>	1.22			

<u>Average Seat Share of Plausible Parties</u>	
<u>Country</u>	<u>Avg. Seat Share (%)</u>
Estonia	1.00
Poland	0.97
Slovakia	0.81

*Average annual number of questions asked per MP

Sources: Grzymala-Busse (2007), 14; Grzymala-Busse (2003); Verkhovna Rada Department of Control (Ukraine)

able to delegitimize the opposition and to blur the line between state and party.”⁶⁵ Surely, other factors besides the dominance of the HZDS also contributed to the ease of privatization fraud. Among these were manipulation of the electoral law along with other restrictions on political competition and parliamentary power in addition to controls on the media. But all of these factors stemmed from a weak parliamentary opposition unable to prevent the ruling coalition from adopting such antidemocratic measures in the first place.⁶⁶

It would not be until 1998, when the HZDS essentially threatened them with “legal extermination,” that anti-government parties finally got their act together and united in the run-up to the September parliamentary elections. And even then, they lost to the HZDS! It was only because the latter proved unable to form a coalition that the opposition finally managed to enter government.⁶⁷

Even after 1998, the opposition remained weak and divided. Róbert Fico broke off from the Party of the Democratic Left (SDL) in 1999 to form Direction-Social Democracy (Smer-SD). This created division within the ranks of the parliamentary opposition. In addition, although Smer harshly criticized both the post-1998 SDKÚ government as well as the HZDS, in the 2002 election it created ambiguity in the minds of voters by refusing to name its potential coalition partners in a future government or even rule out cooperation with the HZDS. Meanwhile, the HZDS would split under the weight of infighting before the 2002 election, thus reducing the chance that it too could

⁶⁵ Ibid.

⁶⁶ Ibid., 77.

⁶⁷ Ibid.

pose a viable threat to the government.⁶⁸ The result was that the SDKÚ-led coalition was re-elected to power for another four-year term in 2002. Even afterwards, however, opposition parties demonstrated a persisting lack of credibility when it came to their efforts to unseat the government. The HZDS then lost its status as the biggest opposition party when in February 2003 it suffered even further defections.⁶⁹ The SDKÚ would eventually fall to defeat at the hands of Smer in 2006. But that would only usher in yet another sustained period of rule by a single coalition, interrupted by a brief 18-month interlude from 2010 to 2012.

The main reason why party competition was as weak as it was in Slovakia was the failure of the Communist Party of Slovakia to transform itself into a modern-style social democratic party after losing power in 1989. Instead of reinventing itself, its members broke away to join a host of other emerging parties, in particular the HZDS, the SNS, the ZRS, and the Democratic Union (DU). A successor to the Communist Party would indeed arise in the form of the SDL. However, it would never pose a major threat to the HZDS; indeed, on a number of occasions it considered joining the ruling coalition. Until the fall of the third Mečiar government in late 1998, virtually all governments were, to a considerable extent, ruled by ex-communists rather than opposed by them.⁷⁰

To be sure, the Slovak party system was quite strong compared to Ukraine's. The latter was not much of a party system at all but rather a collection of ever-shifting and ideologically-vacuous factions. They called themselves parties but many instead served as instruments for powerful business interests to extract state resources under the cover of immunity for parliamentary deputies. Slovak parties, on the other hand, were real organizations with definite and identifiable stances on the main issues of the day, from the morally conservative and economically liberal KDH to the hard-left ZRS, the radical nationalist SNS and the populist, left-wing HZDS (at least until 2000, when the party tried rebranding itself as a center-right organization). Although subject to frequent splits, realignments, and the formation of new parties, most Slovak parties have longstanding histories and represent "brand-names" to the electorate. The KDH and SNS each formed in 1990 and the HZDS in 1991. All continue to be represented in parliament today. The center-right SDKÚ, which coalesced before the 1998 elections and was officially registered in 2000, also remains active in parliament. Moreover, Slovak political parties actually form governments. In Ukraine, by contrast, the President has been able to appoint and dismiss the government almost at will for most of the country's post-communist history.

The point is not that Slovakia lacks a real party system; it is rather that the level of party competition was not sufficient to prevent rampant privatization fraud. Even if competition was stronger than in Ukraine, it still was not strong enough. Ruling parties have generally not faced constant monitoring, the fear of losing coalition partners, or the credible threat of removal in national elections.

The upshot of lackluster party competition has been a succession of governments with broad leeway to privatize state assets to their cronies. This was especially true in the

⁶⁸ Tim Haughton, "'We'll Finish What We've Started': The 2002 Slovak Parliamentary Elections," *Journal of Communist Studies and Transition Politics* 19, no. 4 (2006): 76-78.

⁶⁹ Martina Pisárová, "HZDS falls apart as dissenters leave club," *Slovak Spectator*, 17 February 2003 (<http://spectator.sme.sk/articles/view/11864/>).

⁷⁰ Grzymala-Busse, 76.

1990s under the HZDS. As Grzymała-Busse argues, “[t]he weakness of the opposition let Mečiar’s HZDS exploit the state with little constraint.”⁷¹ Nevertheless, for the purpose of this study, the main form such exploitation would take was corruption in the formal privatization process - including but not limited to the biggest state enterprises. After all, robust party competition in Poland did not prevent its elites from taking advantage of other, more informal soft budget schemes; they used such methods as tunneling state enterprises and concluding overpriced contracts with state agencies in order to siphon public resources to great effect.

But it did matter for privatization. Indeed, it was in December 1994 – soon after the elections that brought Mečiar to power for the third time and when the opposition to him was arguably at its weakest – that the HZDS managed to push through the two laws that took away any semblance of accountability from the privatization process. The first of these laws transferred authority over privatization from the government to the FNM, a non-governmental body completely controlled by the HZDS and which did not answer to parliament. The second law invalidated all privatizations carried out under the previous Moravčík government.⁷²

Thanks to the relatively weak level of party competition, the HZDS managed to severely circumscribe parliamentary oversight of the privatization process particularly by stacking all relevant parliamentary committees and state monitoring agencies with party loyalists and giving all responsibilities for privatization from 1994 onward to the FNM, a semi-private joint-stock company. The Supreme Audit Office (NKU), in particular, had no independent investigative powers and was controlled by the government; during the midnight privatizations of 1994, its head was sacked and replaced by an HZDS-appointee.⁷³ The lack of adequate monitoring by the parliamentary opposition as well as the low threat of removal they posed to the government allowed Mečiar to freely privatize lucrative state assets to his cronies - and at prices that were patently absurd.⁷⁴

The cumulative effect of soft budget constraints, including but hardly limited to fraudulent privatizations, was to cause a severe banking crisis by the time the HZDS was ousted in 1998. Under Mečiar the party used the state banks to extend soft credits to politically connected enterprises, much of which was simply siphoned away. The Dzurinda government would face a financial emergency due to the huge problem of non-performing loans in the banking system. In October 1999 the National Bank of Slovakia (NBS), the central bank, put Priemyselná banka Košice into forced administration due to myriad financial problems and a failure to meet the minimum reserve requirement. In December of that year it revoked the license of AG Banka after concluding its financial position had become unsustainable. The government had far bigger fish to fry the three largest state-run banks; it had to put IRB into forced administration and began a massive restructuring of SLSP and VÚB.⁷⁵ The government then transferred NPLs totaling Sk105 billion, or 12 percent of GDP, to the newly-established Slovenská konsolidačná agentúra (SKA) and Konsolidačná banka (KoB). It recapitalized the three

⁷¹ Ibid., 77.

⁷² “Parliament passes two privatisation laws”

⁷³ Grzymała-Busse, 101, 105.

⁷⁴ Gould, 109.

⁷⁵ “Survey of most important economic events in Slovakia in 1999,” *CTK Business News*, December 27, 1999.

banks with direct equity injections financed by a government bond issue. Ultimately, then, it was the taxpayers who had to shoulder the burden of recapitalizing the banks after their assets had been stripped by HZDS cronies.⁷⁶

This section has given a general overview of the way in which soft budget constraints engineered the rise to prominence of political thugs, particularly in the key formative years of the 1990s. The following discussion will turn to specific case studies from during and after this period, focusing first on the non-plutocratic elite and then on the plutocrats.

The Non-Plutocratic Elite

Taken together, the extremely liberal use of soft budget constraints, both licit and illicit, ended up channeling huge amounts of state assets into the hands of one particular segment of society: individuals and organizations with a comparative advantage in the use of force. Whether beginning their careers as organized-crime enforcers or, alternatively, state officials and their cronies, a new class of political thugs was able to grow and take root as a result of the plentiful state assets available to those with the right connections. The fact that all of the non-plutocratic raids documented in this chapter (for which sufficient information is available) were the work of political thugs suggests that these sorts of business actors, like the raids they undertook, are quite well-represented among this stratum (Table 5.2).

Indeed, the very political ties to the state's agents of force that served them so well in the siphoning of public resources would also enable many political thugs to embark on careers as criminal corporate raiders. Raiding among the non-plutocratic elite is very widespread; of the nine economic sectors identified in the United Nations' ISIC Rev. 4 classification that do not have substantial state ownership,⁷⁷ eight have witnessed at least one raid (the only sector in which I did not find any raids was construction). Most have featured many more raids than that (Table 5.2). Table 5.7 breaks down the various non-plutocratic raids by the raiding indicators that are present in each.

As previously noted, the causal links between soft budgets, the rise of political thugs, and criminal corporate raiding were not a one-way street; each successive development generated feedback effects on factors causally prior to it. The feedback effects highlight how variables at later stages of early capitalism, such as capitalist competition, can act upon factors at previous ones, such as capital accumulation. The enrichment and empowerment of a class of political thugs under the Mečiar governments not only led to widespread raiding in the 1990s; it enabled these actors to successfully push for further soft budget constraints of the kind responsible for their rise to prominence in the first place. Their subsequent engagement in raiding helped them acquire still more wealth. They could then use this wealth to expand their financing of political parties and, in turn, place more representatives in key state positions. Having gotten them appointed, they would gain even greater access to soft budget constraints,

⁷⁶ "Slovakia Risk: Financial Risk," *Economist Intelligence Unit - RiskWire*, September 5, 2003.

⁷⁷ Recall from Chapter One that, of the ten sectors that make up the High-Level SNA/ISIC Aggregation (A*10) in *ISIC Rev. 4*, I excluded one: "public administration, defence, education, human health and social work activities (O, P, Q)." The reason for its exclusion is that it often features high levels of state ownership which additionally may vary considerably across countries.

Table 5.7. Alleged Non-Plutocratic Raids: Confirmation Indicators

Indicator Key	
<u>Indicator #</u>	<u>Description</u>
1	Many domains
2	Spontaneous public actions
3	Unrelated offenses
4	Non-existent laws
5	Suspicious bankruptcy / redistribution
6	Repeated investigations/prosecutions
7	State action in midst of political conflict
8	Direct force
9	Threats made
10	State actions ruled (or suspected to be) illegal
11	Target is a rival of powerful interests
12	#2, 8, or 9 coincides with state action
13	Illegal board meeting

<u>Raid #</u>	<u>Target</u>	<u>Indicators</u>													<u>Substantiated?</u>	
		1	2	3	4	5	6	7	8	9	10	11	12	13		
1	Tesla Stropkov									X						Yes
2	NCHZ									X				X		Yes
3	IRB													X		Yes
4	Incheba									X				X		Yes
5	Glance House									X						Yes
6	TV Markíza								X							Yes
7	Concrete panel factory															No
8	Drukos									X						Yes
9	Nitra Sugar Factory									X						Yes
10	Ján Vovčík's farm				X					X						Yes
11	BMG, Horizont									X						Yes
12	Devin Banka creditors								X							Yes
13	Milan Špak/ Chemko Strážske									X						Yes
14	Mineral-Invod									X						Yes
15	Yukos/Transpetrol									X				X		Yes
16	Chirana-Prema									X						Yes
17	Bratislava Options Exchange							X								Yes

increasing their asset holdings further. In this way political thugs acquired an increasing level of influence over political life. Thanks to this influence, future governments, even those with the best reformist intentions at the outset, would find it increasingly difficult to counter them. The following sections will turn to specific case studies, showing in the most gruesome detail how these processes played out among particular members of this nefarious business elite.

The Mečiar Era

Some of the first documented examples of criminal corporate raiding in Slovakia occurred when the third Mečiar government illegally and retroactively annulled dozens of privatizations carried out under Moravčík. In some cases, the companies had already passed into the hands of the new owners. Nevertheless, the HZDS simply transferred the assets back to the National Property Fund (FNM). One of these raids involved Tesla Stropkov, a manufacturer of cables.⁷⁸ As the Finance Ministry was in the process of seizing the firm, the Bratislava Municipal Court ruled in favor of Tesla's new owner, declaring the ministry's efforts illegal. Even so, the head of the state securities register was sacked after refusing to go along with the transfer, despite the court ruling.⁷⁹

Another Moravčík privatization the new FNM sought to reverse was the sale of the Novácke Chemicals Plant (NCHZ) to Inekon, a Czech company.⁸⁰ In 1994, Inekon won a tender for 51 percent of NCHZ, which enjoyed a lucrative monopoly on the production of PVCs, a type of plastic.⁸¹ Despite the fact that Inekon had already concluded the purchase, the FNM now refused to transfer all the shares to Inekon. It persisted in its refusal despite two court decisions over the next few years that confirmed the validity of the sale.⁸² In 1995, the FNM convened an extraordinary shareholders meeting and elected its own supervisory board, which subsequently approved the issuance of new shares. The result was the simultaneous existence of two parallel boards and managements, one representing the FNM and the other representing Inekon, the rightful owner. The Bratislava City Court later ruled that the meeting and share emission initiated by the FNM were illegal.⁸³

Finally, in July 1997, the state relented and transferred to Inekon the shares it was due. But the very next day, 32,000 shares were illegally transferred out of Inekon's account at the securities registry. Over the next four days, a further 128,000 shares vanished. As a result, Inekon watched what had been a 51 percent stake in NCHZ fall to 41 percent.⁸⁴ Inekon's woes mounted further in July 2000 when the new majority owner

⁷⁸ Non-Plutocratic Raid #1 (NPR #1)

⁷⁹ "SCP director was removed for unsatisfactory results – ministry," *CTK Business News*, February 17, 1995.

⁸⁰ NPR #2

⁸¹ "Slovak SCP transfers 2% of NCHZ shares from Inekon account," *CTK Business News*, July 11, 1997.

⁸² "Inekon now only has 41 percent of NCHZ shares on its account." *CTK Business News*, July 15, 1997; "Sale of chemical producer was legal – Schmognerova," *CTK Business News*, September 27, 1994.

⁸³ "Court annuls results of extraordinary general meeting at NCHZ," *CTK Business News*, December 15, 1995; "INEKON denounces FNM moves in NCHZ dispute," *Pravo*, December 11, 1995.

⁸⁴ "Inekon withdraws from contract on buying majority in Slovak NCHZ." *CTK Business News*, July 18, 1997; "Inekon now has only 41 percent of NCHZ shares...;" "Selection of events in Czech Republic's economic life in 1997." *CTK Business News*, December 29, 1997.

of NCHZ obtained a court ruling authorizing the issuance of still more new shares and excluding Inekon from purchasing any. This had the effect of reducing Inekon's stake even further, from 41 percent to 33.5 percent. Another court decision later deemed that share emission illegal. In addition, the Justice Ministry began investigating whether bribery had been used to secure the first court decision that authorized the share issuance.⁸⁵ The alleged beneficiaries of the raid on NCHZ were individuals related to Anna Nagyová, Mečiar's "right-hand woman," particularly her husband, Marián Mojžiš, and his nephew, Ivan Mojžiš.⁸⁶

Some of the most prominent political thugs around the HZDS were individuals linked to VSZ, the giant steelmaker. As mentioned earlier, they managed to privatize 9.5 percent of the company to themselves during the final days of Mečiar's second premiership. To purchase the shares they established the creatively-named Manager, a.s., perhaps to highlight the fact that the privatization would indeed be awarded to the plant's own managers. The FNM, under the control of Lexa and Mečiar, sold the stake for far less than it was worth and on a very generous payment schedule. Moreover, the little money that was required to purchase the shares came in the form of an interest-free loan to the five owners of Manager, a.s. The loan itself was provided by a Košice-based bank owned by a fund controlled by VSZ. The bank, in turn, obtained the funds from Banka Slovakia, which handled banking services on behalf of the FNM. "In short," writes Gould, "Manager borrowed FNM funds to buy shares from the FNM that in turn benefited close associates of its directors and the man responsible for their appointment - Mečiar."⁸⁷

Banka Slovakia itself had been established by Mečiar in 1993 for the purpose of channeling funds in the form of cheap loans from the FNM to firms in his home region of Banská Bystrica. "After the VSZ deal, however, the opposition charged that [the bank] would be used as a means of providing the politically-connected with cheap capital to make down payments for privatization deals." The Moravčík government subsequently revoked its operating license but Mečiar managed to get it restored once he returned to power. Unsurprisingly, "the bank," Gould notes, "like most Slovak banks... quickly developed a problem with nonperforming loans."⁸⁸

Who were the political thugs at VSZ that got their start in business through soft loans and self-dealing in the company's assets? To begin with there was Július Tóth, who had a leading role in VSZ's financial operations until he left in 1992 to assume the post of Finance Minister in Mečiar's second government. In his official government role, he was instrumental in engineering the 1994 privatization of VSZ to Manager, a.s. Later, in 1995, Tóth left to become the head of DMD Holding, an umbrella company set up to consolidate and restructure Slovakia's fledgling arms industry. DMD profited mightily from tax breaks issued under the state's Revitalization Act, ostensibly for the purpose of restructuring the country's engineering and machinery sectors. Nevertheless, almost all

⁸⁵ "Novácke Chemicke Zavody Ends September With Gross Profit 29 Mn SKK." *SITA*, October 22, 1999; "Inekon - Special Meeting of NCHZ Shareholders Illegal." *SITA*, July 9, 1999.

⁸⁶ Boris Hladký, "Pokračuje poprivatizačný presun," *Profíni*, 3 November 2004 (<http://www.profini.sk/pokracuje-poprivatizacny-presun/>); Jana Straková, "Náhoda? Nagyová mala vplyv aj na slovenského premiéra," *Život*, 23 June 2013 (<http://zivot.azet.sk/clanok/13986/nahoda-nagyova-mala-vplyv-aj-na-slovenskeho-premiera.html>).

⁸⁷ Gould, 111-12.

⁸⁸ *Ibid.*, 201.

the proceeds from the tax exemptions went to firms controlled by DMD insiders. Needless to say, very little actual restructuring came of these financial giveaways.⁸⁹ “Far from promoting the Slovak defence sector,” the *Slovak Spectator* wrote, “DMD Holding in the end channeled state firms and billions of crowns in public money into firms controlled by people like Július Tóth.”⁹⁰ After the third Mečiar government was ousted in 1998, the new government forced out Tóth and the rest of the DMD management and filed criminal complaints against them for asset stripping.⁹¹

After Tóth left VSZ in 1992, control of the company passed to Alexander Rezeš and his son, Július. The elder Rezeš would go on to serve as Minister of Transport and Telecommunications in Mečiar’s third government. He succeeded Tóth to become the main liaison between VSZ and the HZDS and was reported to control up to 50 percent of the company along with his family.⁹² In his role as minister, Rezeš helped siphon assets from the state for the benefit of VSZ. The siphoning occurred through a variety of soft budget mechanisms, ranging from reduced transport tariffs to Slovak State Railways, the state’s repayment of money VSZ borrowed to participate in a joint venture with Ukrainian steelmaker Krivorižstal (a loan the state had no business repaying since it had no equity interest in the project), and the direct sale of two banks by Rezeš’s own transport ministry to VSZ.⁹³

Under Mečiar, VSZ developed into an enormous and diversified conglomerate encompassing not just steel production but also media, banks, travel agencies, and sports. “The Rezeš family led a lavish lifestyle,” writes Sharon Fisher, “and after a scandal emerged in 1996 about private planes used by the minister’s family, Rezeš said that he had paid for the flights with his own money, which he claimed he had received through long years of honest work.” After leaving his ministerial position in 1997, he went straight back to VSZ, where he won election as board chairman. He would remain a firm and committed Mečiar loyalist to the bitter end, insisting that the country really needed “ten Mečiar,” causing millions of Slovaks to shudder at the very thought.⁹⁴ Rezeš reportedly had links to Róbert Holub, the Košice organized crime boss who was among the chief organized crime figures connected to the state intelligence agency under Mečiar (more on that below).⁹⁵

One of the biggest coups for the political thugs who controlled VSZ was the highly questionable privatization in 1996 of 40 percent of IRB, one of Slovakia’s biggest banks. Slovak law requires central bank approval for any company attempting to purchase more than 15 percent of a bank. After the central bank rejected VSZ’s bid, the company went ahead with its plans anyway; it simply had 147 of its subsidiaries purchase smaller stakes so that none would exceed the 15 percent threshold. VSZ proceeded to

⁸⁹ Ibid., 111, 127-28.

⁹⁰ Tom Nicholson, “From cheerleader to referee: The state and Slovak arms exports, 1993-2002,” *Slovak Spectator*, 28 October 2002

⁹¹ “Will Former Chiefs of DMD Holding Sue Černák?” *Tlacova Agentúra Slovenskej Republiky*, January 29, 1999.

⁹² Sharon Fisher, *Political Change in Post-Communist Slovakia and Croatia: From Nationalist to Europeanist* (New York: Palgrave-Macmillan, 2006), 83-100.

⁹³ Mikloš.

⁹⁴ Fisher, 83-100.

⁹⁵ “Police silent on East Slovakia gang war as mafia boss shot dead.” *CTK Business News*, October 6, 1997.

raid IRB (which at the time was mostly privately-owned)⁹⁶ by colluding with the FNM to install its own representatives in five of the six positions on the bank's Board of Directors.⁹⁷ The new directors had little to no banking experience. But an understanding of the finer points of banking would not be required for what VSZ had in store, which was to drain the bank of capital to finance its various shenanigan corporate acquisitions.⁹⁸ After running the bank into the ground, VSZ would later be forced out by the Dzurinda government. Aside from IRB, the VSZ boys also bankrupted the country's largest insurance firm, Slovenská poisťovňa. VSZ had acquired the insurer thanks to a new share emission from the state in which the government politely declined to take part.⁹⁹

Senior HZDS figures also allegedly orchestrated a raid on Incheba, an events organizer.¹⁰⁰ After accusing its director, Alexander Rozin, of fraud, IMBA, a minority owner of Incheba, obtained court approval to hold an extraordinary shareholders meeting. Despite the fact that it was providing fake documents, IMBA managed to persuade a judge not only to let the meeting go forward but also void the shares owned by Rozin and his relatives. IMBA, allegedly representing the interests of top-level HZDS officials, proceeded with the shareholders meeting while preventing the Rozin faction from attending, a move which violated the commercial code.¹⁰¹ Nevertheless, the court decision was eventually reversed and Rozin was able to hold onto the company.¹⁰²

Another political thug who grew rich from soft budget constraints courtesy of the HZDS is Fedor Flašík, the owner of an advertising empire. Flašík headed the HZDS election campaigns of 1994 and 1998. Under successive HZDS governments, Donar, his advertising firm, was granted lucrative contracts by the state; as Ivan Mikloš pointed out, "State monopolies, such as Slovenské elektrárne or Slovenské telekomunikácie, use Donar, an advertisement agency close to the government, to organize expensive and unreasonable advertisement campaigns whose only purpose is to transfer funds from [state] monopolies into the coffers of private businesses and their politically connected owners."¹⁰³ Among the contracts Flašík obtained was one from IRB after the latter had been taken over by VSZ. The agreement made Flašík's company, VOSS, the exclusive provider of advertising services to the bank. The contract stipulated severe financial remedies paid to the benefit of VOSS in the event that the bank used the services of any other firm. Lo and behold, in 1998, IRB willfully signed a contract with a different agency despite explicit warnings from its own legal department of the financial consequences under the VOSS contract. Was it all a setup, the product of deliberate collusion between Flašík and his HZDS cronies who controlled IRB? That remains unknown. What is certain is that Flašík reaped benefits from the contract violation, winning damages from the state of Sk104 million in a 2000 court battle.¹⁰⁴

⁹⁶ NPR #3

⁹⁷ Gould, 128-29; Mikloš.

⁹⁸ "Control Freaks." *The Economist*, August 27, 1998.

⁹⁹ Ibid.

¹⁰⁰ NPR #4

¹⁰¹ ("IMBA triggers off scandal around Incheba." *CTK Business News*, August 4, 1997; "IMBA uses fake stamp for calling Incheba meeting." *CTK Business News*, August 6, 1997.

¹⁰² Interview with Respondent #55

¹⁰³ Mikloš.

¹⁰⁴ "Mikloš - Government Going after Former IRB Officials in Sk104m Lawsuit." *Tlacova Agentúra Slovenskej Republiky*, November 18, 2003.

Miroslav Výboh, a businessman involved in the arms trade, was another political thug close to the HZDS. Not only did he enjoy friendly relations with the Mečiar government; he has boasted strong ties to virtually every government in the post-communist era. Under Mečiar, he made a fortune as part of a group called Katrim Stella. The consortium was appointed by the government to handle the repayment of Russia's debt to Slovakia by acquiring Russian armaments and passing them onto the Slovak government. Výboh's company, Willing, was a member of the Katrim Stella group. Most of the military equipment turned out to be pure junk - MiGs that could not fly, and the like - but firms like Willing made a fortune selling it to the Slovak government and taking a cut in the process.¹⁰⁵ For a company that started out with only \$3500 in capital to become the largest supplier to the Slovak army was quite a feat indeed.¹⁰⁶ In addition to Výboh, the other co-owners of Willing were two Russians, one of whom was a former Red Army officer and the other a prominent ex-KGB operative. The two men sat on the supervisory board of Katrim Stella.¹⁰⁷

Výboh's companies also benefited from soft budget constraints under Dzurinda, which ruled from 1998 to 2006. In particular, he used his contacts in the Economy Ministry to win export licenses for his own companies while making sure they were denied to his competitors. For instance, Way Industry, another of Výboh's firms, profited from sales of the Bozhina, a de-mining apparatus that sells very well on international markets. The original developer of the Bozhina claims that Way stole the technology from him. The developer later invented a similar device called the Diana 44T, which is essentially the same thing as the Bozhina, only cheaper. However, while Výboh consistently won export licenses for the Bozhina, the maker of the Diana 44T was routinely denied licenses, supposedly because of an ongoing court battle between the two firms. Of course, the Economy Ministry felt no need to explain why it denied export licenses to only one of the parties in the dispute while freely granting them to the other side. "It was very clear at the time that Výboh was pulling the strings here," one of my sources commented.¹⁰⁸ Výboh's influence has if anything increased under Róbert Fico, whose governments have been in power for most of the past eight years; one newspaper dubbed Výboh the "éminence grise" of the ruling party.¹⁰⁹

Solid links to the HZDS could provide major benefits to a business actor. But the party's protective umbrella was hardly omnipotent, particularly when it came to more powerful foreign players. In 1996, for example, two of the four owners of shoe manufacturer CEBO Holding were killed in successive assassinations. The murders were likely not part of an attempted takeover but probably stemmed instead from unpaid debts to the firm's business partners in Russia and Ukraine.¹¹⁰

¹⁰⁵ Ľuba Lesná, "Ministry pays off controversial arms trader," *Slovak Spectator*, 26 February 2007; Interview with source.

¹⁰⁶ Margarita M. Balmaceda, "Economic Relations and the Ukrainian-Central European-Russian Triangle," in *On the Edge: Ukrainian-Central European-Russian Security Triangle*, ed. Margarita Mercedes Balmaceda (Budapest: Central European University, 2000), 216 (fn. 35).

¹⁰⁷ Lesná, "Ministry pays off controversial arms trader;" Interview with source

¹⁰⁸ Interview with source

¹⁰⁹ Lesná, "Ministry pays off controversial arms trader."

¹¹⁰ "Zavraždili viceprezidenta a. s. CEBO Holding Slovakia," *SME*, 16 December 1996; "Marián Grznárik: CEBO Holding pôjde do likvidácie, ale výroba obuvi v Partizánskom sa nezastaví," *Trend*, 24 June 1998

While HZDS officials partook in more than their fair share of shameless criminality during the party's reign, certain jobs were too sensitive even for them. The solution was to subcontract these activities to organized crime groups such as those led by Róbert and Eduard Dinič, Miroslav Sýkora, and Róbert Holub.¹¹¹ When it came to the dirtiest of the HZDS's dirty work, these organizations demonstrated their usefulness time and again, allowing Mečiar's governments to maintain plausible deniability in the process. The key liaison between Lexa and the criminal underworld was Jaroslav Svěchota, head of SIS Special Operations and Ivan Lexa's deputy at the intelligence agency.¹¹² The most famous example of collaboration between the SIS and organized crime was the 1995 kidnapping of the President's son, Michal Kováč, Jr. Mečiar allegedly ordered the kidnapping in an attempt to discredit the President, with whom he was feuding at the time.¹¹³ As the government came under increasing fire over the incident, Lexa's SIS allegedly commissioned a criminal gang to murder Róbert Remiáš, a key potential witness.¹¹⁴

In exchange for their assistance, the HZDS ensured a steady stream of siphoned state assets to the political thugs who made up Slovakia's criminal underworld. Lexa, as head of the SIS, allegedly sold \$1 million in arms to a garbage dump for less than their scrap value. Many suspected the sale was simply a way to transfer arms for criminal groups acting on the ruling party's behalf.¹¹⁵ Nevertheless, the heating oil scheme was a far bigger source of illegal soft budget constraints for organized crime groups. Miroslav Sýkora, who dominated the Bratislava underworld during the mid-1990s, played a key role in setting up the heating oil scam. In doing so he made good use of the Russian connections he acquired while studying at the prestigious Moscow School of International Relations during the 1980s.¹¹⁶

The Dinič brothers led another criminal organization associated with the HZDS. According to one of my sources, "When Mečiar would hold secret meetings with various suspicious persons, there would be no policemen present as bodyguards. [The meetings] were guarded instead by Eduard Dinič. This was one of the reasons why Dinič was killed."¹¹⁷ In 1997, the Dinič brothers secured a major contract with Slovenská Poistovňa (SP), the state insurer, to lease part of a ski resort in the Tatra mountains to their company, Šport Tatry. The Sk1.5 million annual payment required from Šport Tatry under the contract's terms was, according to the former director of SP's resort operations, "a ridiculous figure, given that the tax write-offs from these facilities alone were worth Sk12 million a year." Another prominent organized crime boss linked to the HZDS was Róbert Holub. Based in the eastern city of Košice, Holub owned a hotel and casino and

¹¹¹ "Dinič brothers terrorized Bratislava businessmen."

¹¹² Interview with Respondent #55

¹¹³ Nicholson, "Civilian oversight of police needed;" Tom Nicholson, "Pride came before fall," *Slovak Spectator*, 20 October 2008

¹¹⁴ Rosenberger, "Big Brother in a Small Country: The Subversion of the Rule of Law in Contemporary Slovakia," 39-40.

¹¹⁵ Ibid.

¹¹⁶ "Dinič brothers terrorized Bratislava businessmen."

¹¹⁷ Interview with Respondent #55

provided “protection” to local businesses.¹¹⁸ He also benefited from the privatization of food producers in eastern Slovakia before being killed in September 1997.¹¹⁹

As it became increasingly likely that the HZDS would lose power in the 1998 elections, the SIS scrambled to clean up its dealings with organized crime groups. Shortly before leaving office, the agency “went on a shredding spree, destroying 271 files, most involving, according to [the next SIS head Vladimír] Mitro, information on ‘organized crime, drugs, illegal hoarding, selling arms [and] radioactive substances’ and about ‘activities of the underworld, corruption, property, and financial frauds’.”¹²⁰ Conveniently, most of the HZDS’ criminal partners were killed either before or shortly after the party’s fall from power. Investigators eventually concluded that the SIS had been behind the murders.¹²¹ The assassinations were reportedly orchestrated by Svěchota, Lexa’s deputy at the SIS.¹²² Sýkora was the first to fall, in 1997. After his death, the Dinič brothers took control of his gang. But they would only last another year. In May 1998, Eduard was killed in a bomb attack that scattered his body parts over a 100-meter radius. Brother Róbert followed three months later, gunned down in his Mercedes S600 at a Bratislava intersection.¹²³

Lest one mistake who the culprits behind the Dinič brothers’ killings were, a police source claimed that Róbert had been under constant surveillance by the SIS until the day before his murder, when the surveillance operation was suddenly lifted. Clearly, the brothers were coming to be seen as increasingly dangerous to senior HZDS officials as the September 1998 elections approached; the police source, referring to the Hotel Junior, owned by the Dinič brothers, said “It’s not just that we ourselves had operational information that top SIS people used to hang out there, the Dinič brothers themselves used to boast about it.”¹²⁴ Before his death in May 1998, Eduard Dinič had secured a promise from a friend of his, Ivan Mishko, to make sure his assets went to his children in the event that anything happened to him. Mishko tried to follow through on this promise but was stopped by Dinič’s former partners, who wanted the assets for themselves. With the help of a senior official in the “reformist” Dzurinda government (1998-2002), they arranged to frame Mishko’s associate for the murder of Ján Ducky, the Minister of Industry under the HZDS.¹²⁵ The plan appears to have worked, as the list of Dinič’s inheritors includes a former judge, an ex-policeman linked to the HZDS, various Russians, and individuals from the former Yugoslav republics, none of whom are children of Dinič.¹²⁶ Nevertheless, Dinič’s partners did not enjoy their new property for long as most, such as Roman Deák and his brother Maroš, were themselves murdered over the ensuing years.

¹¹⁸ John Chipman, “Czech underworld leaves its mark with death, drugs.” *The Globe and Mail*, February 17, 1998; “Slovak press survey.” 1997. *CTK Business News*, September 29, 1997.

¹¹⁹ “Košice Underworld Boss Shooting Investigated.”

¹²⁰ Rosenberger, “Big Brother in a Small Country: The Subversion of the Rule of Law in Contemporary Slovakia,” 40.

¹²¹ “Dinič brothers terrorized Bratislava businessmen.”

¹²² Interview with Respondent #55

¹²³ “Dinič brothers terrorized Bratislava businessmen.”

¹²⁴ Ibid.

¹²⁵ “Ducky Case - Misko Provides Alibi for Oleg T.” *Tlacova Agentúra Slovenskej Republiky*, December 23, 1999.

¹²⁶ Correspondence with Respondent #55, 2013; “Dinič brothers terrorized Bratislava businessmen.”

The wave of gangland assassinations did not stop there. In 1999, Tibor Papay and nine of his associates were gunned down in Dunajská Streda. Before his death, Papay, who ran extortion rackets in the city, claimed to have operated under the protection of Lexa while the latter was head of the SIS.¹²⁷ According to police, 30 of the 67 murders that occurred in 1997 were professional hits;¹²⁸ that year alone saw 98 bombs go off with another 43 diffused by police.¹²⁹ One third of all murders that took place in 1998 were attributed to organized crime.¹³⁰ Police sources maintain that the scores of murders that hit the Slovak underworld between 1997 and 1999 were linked to the transfer of power from the HZDS to the first Dzurinda government.¹³¹

Although Miroslav Sýkora would not live to see the end of HZDS rule, his gang managed to long outlive its founder. Aside from extortion, drug trafficking, and other conventional criminal activities, his successors have also participated in raiding. One of them, Marián Kočner, retook control of Gance House, a luxury residential development, after having been forced out in 2010 by a rival criminal group.¹³² Kočner used his ties to Deputy Prosecutor-General Dobroslav Trnka to lean on an official in the local cadastral office to transfer the title back to Kočner's company, CDI. The action by Trnka was in clear violation of a ban imposed by the Special Prosecutor's Office on all sales and transfers involving Gance House pending an official ruling in a related criminal case.¹³³

Another raid involving Kočner targeted TV Markíza, a major television channel.¹³⁴ It featured the illegal use of force to solve what actually was a perfectly legitimate business claim. In 1994, Pavol Rusko left his position at the state TV channel to set up TV Markíza along with several partners. At the time he was an ally of Mečiar, a fact which surely helped the new TV station secure a broadcasting license the following year. However, Rusko soon fell out with his patron. Meanwhile, he became involved in a business dispute with Siloš Pohanka, another media mogul. Pohanka had guaranteed a loan to Rusko in exchange for half of Rusko's shares in TV Markíza. Rusko later refused to recognize Pohanka's rights to the stake, and a legal battle ensued. Eventually, Pohanka sold the claim on Rusko's shares to a underworld-linked firm called Gamatex owned by Marián Kočner. Gamatex managed to obtain a court decision affirming its right to the shares. It then took the liberty of enforcing the ruling by sending a group of thugs in overalls to evict Rusko's people from the TV station. Soon afterward, Mečiar fell from power, leaving Rusko in a better position to conclude a deal with Gamatex that finally settled the matter.¹³⁵

¹²⁷ "Perpetrators of most serious mass murder in Slovakia go on trial," *CTK Daily News*, September 16, 2003; "Slovak underworld meets at funeral of five in Dunajská Streda," *CTK Business News*, March 30, 1999.

¹²⁸ Peter S. Green, "Extortion and Protection Rackets Grow Into a Threat to Business : Organized Crime Strangles Slovakia." *International Herald Tribune*, March 6, 1998.

¹²⁹ John Chipman, "Czech underworld leaves its mark with death, drugs." *The Globe and Mail*, February 17, 1998

¹³⁰ Róbert Anderson, "Security in 'mafia' trial tight." *Financial Times*, November 9, 1999.

¹³¹ "Dinič brothers terrorized Bratislava businessmen."

¹³² NPR #5

¹³³ "First charges laid in Gance House case," *Slovak Spectator*, 10 December 2012; Interview with source, 2013.

¹³⁴ NPR #6

¹³⁵ Interview with source; "Slovak minister Rusko compared to Berlusconi." *CTK Daily News*, August 23, 2005; "Rusko Is About to Sell Two-thirds of His Stake in Markíza-Slovakia." *SITA*, December 14, 1999.

Mikuláš Černák was another underworld kingpin with close links to the HZDS. With his thick neck, sleazy moustache, and pet Siberian tigers, “Černák was almost a caricature of an Eastern European gangster,” writes Nicholson. Born in the village of Telgárt, in the province of Central Slovakia, among his first forays into criminal activity was the smuggling of horses across the Slovak-Polish border. He later ran extortion and kidnapping rackets in Banská Bystrica, the regional capital, and by the mid-1990s had eliminated all challengers to his rule over the city’s underworld.¹³⁶

However, the revenue brought in by the rackets likely paled in comparison to the profits he made in the heating oil scam described earlier. Thanks in part to this scheme, which amounted to one big soft budget constraint for well-connected criminals, Černák became a wealthy man. He obtained political backing from the SIS, the HZDS-controlled intelligence agency. Jaroslav Svěchota, the agency’s Deputy Director and liaison with the criminal underworld, was the one who brought Černák into the fold. Černák was tasked with replacing Miroslav Sýkora, following the latter’s murder, as the main executor of the SIS’ dirty business. Shortly afterward, however, he was arrested. Except for a brief period in 2003, Černák has remained in prison ever since. The newest charges against him concern his alleged role in six murders, among which were the decapitation of one former policeman and the killing of another who had been the key witness in the kidnapping of the President’s son. In all, investigators have fingered Černák in at least 39 murders.¹³⁷

Černák’s arbitrary brutality inspired fear even among his closest associates. Referring to his former accomplices who were now testifying against him, a police source described the atmosphere of intimidation Černák created. “I sat in on most of those interrogations, and these guys were terrified of him. He would call them up in the middle of the night and tell them to get dressed and go downstairs. They would have no idea where they were going and what they would have to do when they got there. At the slightest hesitation he would be capable of shooting any gang member on the spot. We even intercepted a few SMS messages from gang members saying that Černák was taking them out into the woods, and they were afraid they weren’t coming back. And quite a few of them didn’t.”¹³⁸

Given his background, it should come as no surprise that Černák has been linked to criminal corporate raiding. Upon his arrest in 1998, one of the charges against him involved his alleged attempt to force a businessman to cede control of a concrete panel factory.¹³⁹ He reportedly tried to do the same to another businessman, František Mojžiš.¹⁴⁰ Instead of handing over to Černák his \$150 million-a-year auto leasing company, Drukos, he instead donated it to the Catholic Church.¹⁴¹

Among the other illegal business the HZDS hired out organized crime elements to assist with was criminal corporate raiding. The victim of one such raid was Dušan Sopko, owner of the Nitra Sugar Factory.¹⁴² In 1996 he was visited by a criminal gang headed by Ľuboš Ferus, the alleged boss of the Nitra underworld. Claiming to represent

¹³⁶ Tom Nicholson, “All hands against him,” *Slovak Spectator*, 25 December 2008.

¹³⁷ Ibid.

¹³⁸ Ibid.

¹³⁹ NPR #7

¹⁴⁰ NPR #8

¹⁴¹ Green, “Extortion and Protection Rackets...;” Chipman, “Czech underworld...”

¹⁴² NPR #9

the HZDS, the men announced that they would take control of the factory unless Sopko paid a bribe of Sk20 million to local HZDS figures and hire one of the gang's members as his assistant. After Sopko went to the police, the criminals threatened to kill him, prompting him to flee the country with his family.¹⁴³ In addition to Ferus' gang, an HZDS municipal deputy in Nitra was also allegedly involved in the threatened takeover of the sugar plant.¹⁴⁴ Sopko briefly returned to Slovakia in 1997 to make his allegations public but soon came under pressure from the SIS, which began investigating his past and that of his associates without any legal basis.¹⁴⁵

SIS officials who served under Mečiar were linked to raids of their own. Vladimír Strýček, a policeman before 1989, became an intelligence officer after the revolution, first at the federal level and then in the SIS, where he served until 2004. He fell from grace in that year after police Vice President Jaroslav Spišiak publicly accused him of involvement in the so-called "bankruptcy mafia." In this scheme, Strýček colluded with bankruptcy judges and trustees to force otherwise healthy companies through the bankruptcy process. The assets of these firms were then sold off to the individuals behind the scam (Strýček later sued Spišiak for libel.¹⁴⁶ He was also investigated for his alleged involvement in the heating oil scheme, although the charges were later dropped by Prosecutor-General Trnka in 2010.¹⁴⁷ In addition, Strýček's name was linked to another scam in which property developers used white horses to accept money from creditors and investors, only to go "bankrupt" later.¹⁴⁸

The Post-Mečiar Era

The downfall of the HZDS in late 1998 and its replacement by the pro-reform Dzurinda government spurred hopes that lasting change would finally come to Slovakia. Nevertheless, the eight-year rule of his SDKÚ-led coalition offers up an all-too-typical example of how power can corrupts initially well-intentioned reformers. Dzurinda's premiership began on a high note as some of the major fraudulent privatizations of the Mečiar era were reversed with the assets handed back to the state. Among the cancelled sales were Nafta Gbely (Poór), Slovnaft (Hatina), a controlling stake in VSZ (the Rezeš family), and a spa in the town of Piešťany (Soboňa). Nevertheless, the government ended up cutting the number of suspicious privatizations identified by the National

¹⁴³ "Ferus Accused of Attacking Public Servant." *TASR*, January 14, 1998; "HZDS allegedly involved in blackmail cases." *CTK Business News*, November 20, 1997.; "Nitra Racketeers in Custody," *SME*, 31 January 1998; Chipman, "Czech underworld..."

¹⁴⁴ "Jambor Sues Sopko for False Accusation," *TASR*, November 24, 1997.

¹⁴⁵ "Review of Slovak Press." *TASR*, December 5, 1997.

¹⁴⁶ "Strýček nevysúdil od Spišiaka odškodné ani ospravedlnenie," *Topky.sk*, 7 May 2009, accessed 9 August 2014 (<http://www.topky.sk/cl/10/457200/Strycek-nevysudil-od-Spišiaka-odškodne-ani-ospravedlnenie>).

¹⁴⁷ "Zastavili trestné stíhanie vóči Vladimírovi Strýčkovi v kauze 'olejárrov'," *Nový Čas*, 9 March 2010 (<http://www.cas.sk/clanok/155384/zastavili-trestne-stihanie-voci-vladimirovi-stryckovi-v-kauze-olejarrov.html>).

¹⁴⁸ Leo Mráz, "V problémovom bytovom družstve v Lamači erdzia biele kone," *Plus 7 dní*, 7 November 2012 (<http://www.pluska.sk/plus-7-dni/domov/07/v-problemovom-bytovom-druzstve-lamac-erdzia-biele-kone.html>).

Property Fund from 186 to only 15.¹⁴⁹ Evidently, Dzurinda did not wish to rock too many boats.

Top-level officials in his government would later become embroiled in myriad scandals involving the provision of illicit soft budget constraints. For instance, leaked transcripts of bugged conversations revealed corrupt deals between Transport Minister Gabriel Palacka and Ján Badžgoň, a businessman and prominent SDKÚ supporter. The transcripts suggest that the Dzurinda government handed out state contracts to favored construction firms, particularly for an ambitious highway construction project.¹⁵⁰

In addition to soft budget constraints, criminal corporate raiding would similarly continue apace under Dzurinda and later, Róbert Fico. A particularly remarkable case, even by Slovakia's standards, occurred in the small town of Kalná Roztoka. There, a small land tax erroneously levied upon a farmer ballooned into the court-mandated seizure of his entire property.¹⁵¹

In 2002, Ján Vovčík received a land tax bill for Sk30,000. The problem was that the land on which the tax was assessed was owned not by him but rather by the local Greek Catholic diocese. The notice stated that "appeals to this decision can be submitted within 30 days." Vovčík duly submitted an appeal but it was rejected by the Kalná Roztoka mayor on the grounds that the deadline had already passed - even though the "deadline" to which the mayor referred was 15 days after the notice date, not 30. In a clear violation of the law, the mayor refused Vovčík's right of appeal to the tax office in Banská Bystrica.

Not to worry; the matter was now safely in the hands of the courts, who would surely clear up the matter and see to it that Vovčík's property rights were restored. Alas, that would not happen. In 2003 the Humenné district court authorized a court executor to proceed with the collection of the non-existent debt. Vovčík appealed the decision, but the judge, Jana Kurucová, rejected his appeal, making the bizarre claim that her court was not permitted to rule on the validity of the original tax decision by the town authorities. To the contrary, Slovakia's Execution Code clearly mandates that courts review all stages of the execution process and overturn any rulings where, to quote the Code itself, "the execution should never have started because the decision to execute was invalid at the time it was issued."

The raiders were not going to let such legal niceties ruin their takeover, and in July 2005 local authorities moved to collect on the debt. However, instead of selling a single piece of his property to repay this "debt" that should never have been levied in the first place - a truck would have sufficed - they auctioned off his entire farm. To make matters worse, the court evaluator, Jozef Galanda, valued the farm at Sk2.4 million despite having assessed it at Sk8.5 million just a few years earlier. This enabled the property to be sold cheaply to whomever had the right connections with the local authorities. These connections turned out to belong to two former policemen, Andrej Fedorko and Ján Glogovský, who had been fired in the late 1990s for cigarette smuggling. Having gotten their start by siphoning tax revenue from the government, it was only natural for these political thugs to move into criminal corporate raiding.

¹⁴⁹ "Clean Hands campaign proving a failure," *CTK Business News*, March 15, 2000.

¹⁵⁰ "Slovakia politics: Secret service scandals," *Economist Intelligence Unit - ViewsWire*, June 16, 2003.

¹⁵¹ NPR #10. The following comes from Tom Nicholson, "Owner loses farm to 'eastern justice'," *Slovak Spectator*, 15 September 2008

Another series of raids in the Dzurinda-era involved the spectacular collapse of several unlicensed deposit companies in 2002. František Mojžiš, the one who had earlier donated his business to the Catholic Church rather than hand it over to Mikuláš Černák, was himself a central figure in this episode. His BDV Družstva was among the funds that collapsed. He was arrested for his role but prosecutors dropped the charges against him - even though he admitted that some of BDV's deposits were used to pay back other creditors in the classic style of a pyramid scheme.¹⁵²

The downfall of Mojžiš' funds followed similar collapses at BMG and Horizont,¹⁵³ both of which were run by Jozef Majský and his associates, Patrik Pachinger, David Brtva, František Matik, and Vladimír Fruni.¹⁵⁴ They had allegedly made their initial fortunes collaborating with the SIS to smuggle arms to Croatia during the wars of Yugoslav succession. They later founded BMG and Horizont.¹⁵⁵ Promising investors sky-high returns, the funds simply paid off old depositors with the funds of new depositors. The collapse of the funds caused a major scandal as tens of thousands of investors saw the value of their holdings evaporate.¹⁵⁶

In October 2002, in the aftermath of the crisis, Majský and several associates were arrested and charged with fraud and embezzlement. They were quickly released by court order. After fleeing to the Czech Republic, Majský was arrested a second time in January 2003 but released a once again at the behest of Prosecutor General Dobroslav Trnka. With prosecutors and judges - our agents of force - apparently inclined to let them get away with their tunneled wealth, it took the creation of a Special Court, under the direction of a Special Prosecutor, to finally bring the conspirators to justice. They now reside in prison.¹⁵⁷

Some raids in the post-Mečiar era even turned violent. One such case involved the tunneling of Devín Banka. Set up in 1993, the bank benefited from illicitly-obtained soft-budget constraints under the HZDS. In 1995, Karol Martinka, an HZDS crony who won a number of fraudulent privatizations under Mečiar, became the bank's director. Under Martinka's leadership Devín Banka secured a huge contract from the Finance Ministry to receive arms imports from Russia as repayment for the latter's debt to Slovakia. In exchange for its services the bank was granted a whopping 20 percent commission. Igor Cibula, the onetime security officer for the Czechoslovak state intelligence agency, referred to Devín Banka in 1998 as "the Trojan Horse of Russian interests in Slovakia." More debt-settlement contracts from the Finance Ministry followed in 1997.¹⁵⁸

¹⁵² "Drukos Company Faked Turnover." *TASR*, May 24, 2002; "Prosecutor Drops Charge against Mojžiš," *TASR*, April 5, 2002.

¹⁵³ NPR #11

¹⁵⁴ "Slovak businessman Majský's case at court." *CTK Daily News*, November 5, 2004.

¹⁵⁵ "SIS agents suspected of weapons smuggling - press," *CTK Daily News*, September 27, 2004.

¹⁵⁶ "Slovak businessman Majský's case at court."

¹⁵⁷ "Supreme Court Confirms Prison Terms for Fruni and Matik." SITA, May 30, 2007; "Convicted Vladimír Fruni in Prison Hospital after a Heart Attack." SITA, August 7, 2007; "Slovak court upholds 11.5-year sentence for businessman Fruni." *CTK Daily News*, May 30, 2007; "Slovak businessman Majský's case at court."

¹⁵⁸ "Investigation of Devín banka crime ended," *Slovak Spectator*, 23 August 2004; "Ex-SDE member among Devín banka accused," *Slovak Spectator*, 13 February 2006

Having amassed such riches from soft budget constraints, Devin Banka naturally became the victim of massive tunneling by its own managers. According to former Finance Minister Ivan Mikloš, the bank “became famous for its problematic management and unrivaled, at least by Slovak standards, growth of classified [i.e. non-performing] loans.¹⁵⁹ The tunneling of Devin Bank spanned multiple governments. Even after the HZDS fell from power, it continued under the stewardship of criminals associated with the Democratic Left Party (SDL), the successor of the communist party and a member of the “reformist” coalition that replaced Mečiar in 1998. Between 1998 and 2001, an SDL-linked company called Apis took out huge amounts of loans from the bank and ultimately drove it into bankruptcy. Sometime later, Apis itself went bankrupt as a result of further tunneling. The asset-stripping continued even while Devin Banka proceeded through the bankruptcy process. After the individuals involved became the target of a criminal prosecution, they attempted to cover up their activities by murdering the white horses they had used to illegally transfer the bank’s assets.¹⁶⁰ The use of violence to assist in the theft of assets rightfully belonging to the bank’s creditors qualifies Devin Banka as a case of criminal corporate raiding.¹⁶¹

In another conflict, a shareholder of Chemko Strážske faked his own kidnapping in order to finger a rival in his disappearance. Martin Babiar allegedly enlisted the help of an underworld figure to intimidate another member of the supervisory board, Milan Špak, into ceding control of the company.¹⁶² Unbeknownst to Babiar, it was all a setup; the man he hired turned out to be a police agent, and Babiar subsequently faced criminal prosecution for this role in the raid attempt (the charges against him were eventually dropped).¹⁶³

Other raids in the post-Mečiar era involved more conventional tactics. In 2009, Slavomír Hatina became the target of an illegal takeover attempt against his mineral water company, Mineral-Invod.¹⁶⁴ Hatina had become an instant energy magnate under Mečiar, with interests in Slovnaft and SPP, and was now expanding into other businesses. The perpetrator of the raid was an organized-crime figure named Libor Jakšík. Jakšík was the former owner of the land on which Mineral-Invod was built. However, Jakšík’s company that had previously occupied the property never became active, with the result that his rights to the complex lapsed. Afterward, Hatina bought the rights to the land and set up Mineral-Invod. One day, Jakšík approached Hatina brandishing what one of my sources called “a bullshit court decision” affirming that his company had been “reactivated” and as such was the legal owner of Mineral-Invod. The decision gave him the rights to the land, the building, and the trademark. Jakšík’s aim was not to actually take over Mineral-Invod (“what does Jakšík know about mineral water?” my source asked rhetorically) but rather to shake down Hatina for a payoff. Hatina did pay him the money but then used his formidable political connections to have Jakšík arrested for extortion, a crime for which he now is serving a prison term.¹⁶⁵ Even if Jakšík’s goal was

¹⁵⁹ Mikloš.

¹⁶⁰ “Investigation of Devín banka crime ended;” “Ex-SDL member among Devín banka accused.”

¹⁶¹ NPR #12

¹⁶² NPR #13

¹⁶³ Monika Tódová, “Slávny prípad sa skončil fiaskom,” *SME*, 2 August 2008; Branislav Sobinkovič, “Chemko Strážske: fabrika, ktorej najväčší vlastníci sa utajujú,” *Trend*, 14 November 2005)

¹⁶⁴ NPR #14

¹⁶⁵ Interview with source

not to acquire all of Mineral-Invod, he certainly had, thanks to the court ruling, the power to shut it down and threatened to exercise that right. For this reason the case of Mineral-Invod counts as a criminal corporate raid.

Transpetrol, the main supplier of Slovnaft, one of the energy companies Hatina controlled, was itself the target of a criminal corporate raid by a businessman named Ignác Ilčišín.¹⁶⁶ In 1995, the Finance Ministry illegally prevented Ilčišín's company from taking control of some real estate, causing damages which, according to Ilčišín's estimate, totaled Sk43.3 million. As "compensation" for these damages, amounting to only a few million dollars, Ilčišín obtained a series of highly controversial decisions by a court and administrator. The rulings awarded to firms controlled by him and his partners 34 percent of the huge energy firm Transpetrol, a stake worth upwards of Sk2 billion.¹⁶⁷ Later court decisions annulled the transfer.

Meanwhile, in 2002, Russian energy firm Yukos bought 49 percent of Transpetrol from the state. Nevertheless, Ilčišín and his associates continued to claim title to the disputed 34 percent stake. When Yukos agreed to sell its shares back to the state in 2009, Ilčišín acted quickly. He convened a shareholders meeting, installed his own representatives on the board, and got himself elected board chairman. Apparently, he wanted the board's approval to sell his non-existent stake in Transpetrol to a Cypriot company. The meeting was plainly illegal, as the previous ruling that awarded Ilčišín the Transpetrol shares had been suspended by the Supreme Court pending review on appeal.¹⁶⁸ Eventually, the courts decided that Ilčišín never was the owner of the Transpetrol shares after all. He was later sentenced to nine years in prison for his role in the attempted takeover of the company.¹⁶⁹ Because the decision made at the illegal shareholders meeting in 2009 placed in jeopardy the rights of a private company, Yukos, to its entire stake in Transpetrol, this case qualifies as an attempted criminal corporate raid.

The Plutocratic Elite

The preceding discussion demonstrates just how ubiquitous criminal corporate raiding is among Slovakia's non-plutocratic elite. We will now turn our attention to the plutocrats. Here, one can observe a similar process whereby soft budget constraints launched the business careers of numerous political thugs. At least 71 percent of the plutocratic elite is made up of political thugs. This is even higher than the comparable figure for Ukraine, where 53 to 65 percent are categorized as political thugs (Table 5.1). What distinguishes the plutocrats from their non-plutocratic counterparts was simply their ability to gain control of the most valuable state assets, both through subsidized privatizations and other soft budget constraints.

The resulting proliferation of political thugs in the plutocratic elite led to widespread criminal corporate raiding among this group. A full 47 percent of the plutocratic elite can be classified as raiders; out of 34 members of this group, 16 have

¹⁶⁶ NPR #15

¹⁶⁷ "Ministry Considers Dispute about 34 Pct. of Transpetrol to be Over." SITA, November 23, 2006
"Struggle over Transpetrol shares," *Slovak Spectator*, 11 May 2009.

¹⁶⁸ "Struggle over Transpetrol shares."

¹⁶⁹ "Slovak state wins again in Transpetrol case," *Slovak Spectator*, 31 October 2013.

Table 5.8. Alleged Plutocratic Raids

Raid #	Target	Alleged Perpetrator	Pol. Thug?
1	Chemolak	V. Lexa, A. Lorenc, Dospiva, Haščák, Kúšik, Oravkin	Y
2	Považské strojárne	V. Lexa, A. Lorenc, Dospiva, Haščák, Kúšik, Oravkin	Y
3	AG Banka	V. Lexa, A. Lorenc, Dospiva, Haščák, Kúšik, Oravkin	Y
4	Creditanstalt	J. Tkáč, P. Tkáč, Korbačka, Jakabovič	Y
5	Istrofin	Hoffman, Prieložny, Siekel	Y
6	Perspektíva	Hoffman, Prieložny, Siekel	Y
7	Slovglass	Hoffman, Prieložny, Siekel	Y
8	Rašelina Quido	Hoffman, Prieložny, Siekel	Y
9	Adria Škrob	Kollár	Y
10	Černovka	Kollár	Y
11	Preglejka Žarnovica	Kollár	Y
12	PSIPS	Juraj Široký	Y
13	PSIS	Juraj Široký	Y

allegedly participated in at least one raid – and most of these individuals are serial, not one-time, raiders (Table 5.1). Tables 5.8 and 5.9 list the various plutocratic raids identified by this investigation and break down each one according to the indicators of raiding that can be observed.

Like in Ukraine, feedback effects among soft budget constraints, the emergence of political thugs, and raiding would play an important role for the Slovak plutocrats, just as they did for the non-plutocratic elite. Similarly to Ukraine, moreover, Slovakia’s plutocrats have mostly stopped relying on raiding as a business tactic in recent years, and for the same reason; most of the large assets that would be of any interest to the biggest players are already spoken for. They have now passed from weaker to stronger hands. This poses serious difficulties to any plutocrats who wish to raid such companies as they would now have to pry them away from other actors of similar strength. In this way, raiding has become too costly for the very richest actors. “You don’t really see it anymore because there aren’t really any good assets left to take over,” Nicholson confirms. “The good assets have all been divided up among the major players.”¹⁷⁰ Nevertheless, like in Ukraine, raiding among the non-plutocratic elite continues unabated, as the previous section made clear.

First, a word is in order on how the list of Slovak plutocrats was compiled. As in the case of Ukraine, I relied on a published ranking of the richest Slovaks to draw up the list (the only such ranking for Slovakia is issued annually by *Týden*, a Czech weekly). However, the consensus among the various specialists I consulted was that two individuals, Vladimír Lexa and Alojz Lorenc, should appear on the *Týden* lists but do not. The reason is that much of their wealth is allegedly held by other plutocrats acting as fronts. I have thus included Lexa and Lorenc in my own top-20 lists, which in turn required bumping off the two people at the bottom of each year’s rankings.

¹⁷⁰ Interview with Tom Nicholson, 13 February 2013

Table 5.9. Alleged Plutocratic Raids: Confirmation Indicators

Indicator Key

Indicator #	Description
1	Many domains
2	Spontaneous public actions
3	Unrelated offenses
4	Non-existent laws
5	Suspicious bankruptcy / redistribution
6	Repeated investigations/prosecutions
7	State action in midst of political conflict
8	Direct force
9	Threats made
10	State actions ruled (or suspected to be) illegal
11	Target is a rival of powerful interests
12	#2, 8, or 9 coincides with state action
13	Illegal board meeting

Raid #	Target	Alleged Perpetrator	Indicators													Substantiated?		
			1	2	3	4	5	6	7	8	9	10	11	12	13			
1	Chemolak	V. Lexa, A. Lorenc, Dospiva, Haščák, Kúšik, Oravkin															X	Y
2	Považské strojárne	V. Lexa, A. Lorenc, Dospiva, Haščák, Kúšik, Oravkin					X											Y
3	AG Banka	V. Lexa, A. Lorenc, Dospiva, Haščák, Kúšik, Oravkin					X						X					Y
4	Creditanstalt	J. Tkáč, P. Tkáč, Korbačka, Jakabovič															X	Y
5	Istrofin	Hoffman, Prieložny, Siekel					X											Y
6	Perspektíva	Hoffman, Prieložny, Siekel					X			X	X							Y
7	Slovglass	Hoffman, Prieložny, Siekel								X						X		Y
8	Rašelina Quido	Hoffman, Prieložny, Siekel			X													Y
9	Adria Škrob	Kollár					X											Y
10	Černovka	Kollár					X											Y
11	Preglejka Žarnovica	Kollár					X											Y
12	PSIPS	Juraj Široký										X						Y
13	PSIS	Juraj Široký				X						X						Y

Any discussion of Slovakia’s ultra-wealthy must begin with the individuals around Penta, J&T, and Istrokapitál, the three largest business groups in the country. Ostensibly founded by young Slovaks then in their twenties, some suspect that the real agents behind their formation were certain powerful ex-communists – namely Vladimír

Lexa and Alojz Lorenc as well as Jozef Tkáč – lurking in the shadows. According to one source, it is “glaringly obvious” that Penta, Istrokapitál, and J&T originated with backing from the same sources. “All three groups started around 1994, 1995, and 1996 and emerged out of no-name stock brokerages. All three transformed privatization funds into joint-stock companies, and all displayed the same rocket-like progression to wealth. So all of this makes it look like they were the front men and that the strategy was handed to them by others who remained in the background...All that’s missing is the smoke and gun evidence.”¹⁷¹

In a series of highly dubious transactions, the three financial groups took control of the country’s largest Investment Privatization Funds (IPFs). Established during the voucher privatization process before the breakup of Czechoslovakia, IPFs bought up vouchers from citizens in return for shares in the funds. They then used the vouchers to participate in privatization auctions, ultimately obtaining small but significant shareholdings in many blue chip companies. In the mid-1990s, under the third Mečiar government, Penta, J&T, and Istrokapitál secured politically-engineered soft loans from state banks to buy controlling stakes in the privatization funds. Upon getting themselves appointed as managers they liquidated the funds’ assets, using questionable methods that enriched themselves at the expense of minority shareholders. In the process they often relied on the help of another plutocrat, Zoroslav Kollár, a specialist in bankruptcies. “Istrokapitál, and particularly Kollár, who worked very closely with them, tended to use this kind of operation,” says one source. “And he also helped to set up Penta and J&T. So that’s why I say there were some incestuous relations between these three even though they acted later on as if they were independent players. But there were similar minds behind the setup of the companies and they functioned in similar ways. And they all involved to some extent a transformation from the investment funds.”¹⁷²

Although the methods they used did not for the most part violate the law explicitly, some observers conclude that they could not have proceeded as they did without the connivance of state officials. Such cooperation, they believe, could only have come as a result of bribery. “That’s the only way it could have happened,” says Oľga Reptová, a privatization specialist and former IPF manager. “These transactions were in keeping with the law but could not have happened without the influence of people in the state apparatus who said ‘yes, I will agree to this.’ The problem is that no one was checking up on the people who decided.” She is specifically referring here to Penta’s acquisition of VÚB-Kupon and Istrokapitál’s takeover of four funds from Slovenská Poistovňa. As for J&T, the fact that one of the founders had a father who was head of IRB, one of Slovakia’s biggest banks, was crucial to its success. “In my opinion,” Reptová says, “it meant the firm [J&T] had access to loans [to buy the IPFs] without going through a tough loan appraisal regime. For me, this is a clear case of the failure of banking supervision [by the central bank].”¹⁷³

Thus, in contrast to Ukraine, questionable privatizations in Slovakia took the form not just of rigged tenders but also the acquisition of the major IPFs. Even though the shares held by the IPFs were already in private hands (the IPFs were mostly privately-

¹⁷¹ Interview with Respondent #47

¹⁷² Interview with Respondent #47

¹⁷³ Tom Nicholson, "Privatization: Paying Lip Service to Morality," in *Investment in Practice Advisory Guide 2002*, ed. Slovak Spectator(Bratislava: Slovak Spectator, 2002).

owned), the takeovers must be seen as part and parcel – and indeed the endpoint – of the voucher privatization process. Just like rigged direct sales, the raids on the IPFs amounted to the blatant use of political connections to redistribute enormous amounts of assets that until very recently had been under state ownership; the IPFs simply represented temporary way-stations for the assets as they passed into stronger hands.

These takeovers, which constituted the end-point of the voucher privatization process, occurred in full public view in a country with an open political system and a vigorous independent press. The problem was that party competition was not strong enough to stop it. In all three cases, tiny brokerages obtained enormous soft loans to buy substantial stakes in the funds, which they subsequently used to gain managerial control. Once in charge, they raided the funds' valuable assets while sticking minority shareholders with the rest. Since then, the three groups have grown into huge conglomerates with diverse holdings in an array of industries, from banking and real estate to health care, media, energy, and tourism.¹⁷⁴

They have also been able to parlay their growing wealth into solid political connections, and not with only one or another political party. Instead, they hedge their bets by giving to each party, making sure to have, in Nicholson's words, "a girl in every port."¹⁷⁵ When he came to power in 2006, Róbert Fico, the new social-democratic Prime Minister, noted the wide-ranging influence of the three groups in Slovak politics. "These financial groups and multinational companies actually ran the [2002-2006] government of Mikuláš Dzurinda," he asserted. Upon his election, he boldly promised that those days were now over. "However," Nicholson writes, "as the recent presence of Fico's finance minister, Ján Počiatek, on board a yacht owned by J&T suggests, two years of 'social democracy' have not hampered the country's financial groups nor severed their ties with politicians."¹⁷⁶

The following discussion will detail how the individuals behind Penta, J&T, and Istrokapitál managed to take over the IPFs and raid their holdings. It will also show how they transformed their newfound wealth into still greater opportunities to siphon state assets and raid private ones.

Penta

According to the "official" account, Penta was founded by four former classmates - Jaroslav Haščák, Jozef Špirko, Martin Kúšik, and Marek Dospiva.¹⁷⁷ Whether or not this "official version" is true remains unclear. Nevertheless, as one particularly credible source asserts, "I think the way in which the political and economic structure was set up after communism wasn't an accident; it was designed fairly deliberately by people who had been senior in the communist hierarchy and particularly in the secret police. These people in Penta, J&T, and Istrokapitál share things in common. For example, they were all pretty young; when they began in business they were all in their mid-twenties. They all studied at select schools in the Soviet Union. They all started with tiny little brokerages and, all of a sudden, came into huge assets, which means that they had

¹⁷⁴ Tom Nicholson, "'Sharks' still thrive in Slovak Waters," *Slovak Spectator*, 7 July 2008.

¹⁷⁵ Interview with Tom Nicholson

¹⁷⁶ Nicholson, "'Sharks'..."

¹⁷⁷ Tom Nicholson, "Who are the richest Slovaks? Private equity firm owners." *SPEX*, September-October.

political clout behind them in order to get the credit, first of all, under Mečiar to get those assets. And also somebody had to bring them the means. It's been credibly suggested that basically they were picked, and they were told 'this is the way you are going to do it – we've got this strategy all set up, and here's some money to go for it.'¹⁷⁸

If the above account is true, the question of just who the people behind Penta are has so far remained unanswered. However, two candidates stand out in particular. The first is Vladimír Lexa, who has been an unofficial consultant to Penta since its early days. The father of former HZDS spymaster Ivan Lexa, Vladimír served as Deputy Prime Minister during the final days of communism in 1989-90. He was also head of the communist-era Slovak Planning Commission. "So he knew exactly which companies were worth privatizing, which ones were producing their yearly plans, and which ones weren't," my source notes. Haščák himself has admitted publicly that he still meets regularly with Lexa, and one can still see the connections between Lexa and Penta's official owners in the business register.¹⁷⁹ Lexa, Sr. was also on the "Cibula list" of individuals allegedly connected to the ŠtB, the communist-era secret service, although he denies that he ever had any such links.¹⁸⁰

Upon being placed in charge of privatization under Mečiar's second government, Ivan Lexa privatized Svikon in a direct sale to his father.¹⁸¹ He also sold Lexa, Sr. several flour mills and bakeries. Later, when the elder Lexa was ready to sell the flour mills, the Mečiar government undertook measures to artificially push up the price of flour, thereby increasing their value.¹⁸² Like his son, Vladimír Lexa enjoyed close ties to Mečiar while the latter was in power. In 1996, a company linked to Lexa bought a majority stake in a publishing firm that owned a number of Slovakia's biggest newspapers. "The shares were ostensibly acquired by brokers Harvardská burzovní společnost [Harvard Investment Company]," according to one news report, "but it is understood the company was acting on behalf of [Vladimír] Lexa."¹⁸³

Aside from Lexa, the second alleged architect behind Penta was Alojz Lorenc, who headed the ŠtB under communism. Officially, he is merely an employee at the conglomerate (it was Vladimír Lexa who recommended he be hired in the first place).¹⁸⁴ Known for his impressive intellect, Lorenc speaks several languages and is thought to have invented the secret code used by the ŠtB to send encrypted messages. "He's not a stupid communist," as one source puts it.¹⁸⁵ Around 2001, Lorenc was pursued by the Special Prosecutor for allegedly having ordered the illegal detention of a group of dissidents from October 1988 to November 1989. He nevertheless got off with a light suspended sentence.¹⁸⁶ "Lorenc is very, very careful," says another source. "I see him in the background, in the shadows of Penta."¹⁸⁷

¹⁷⁸ Interview with source

¹⁷⁹ Ibid.

¹⁸⁰ Tom Nicholson, "The Technocrat," *SPEX*, February 2005

¹⁸¹ "Opposition paper hints SIS head involved in sleaze affair," *CTK Business News*, January 9, 1998.

¹⁸² "Slovak govt unable to cope..."

¹⁸³ "Businessman set to acquire majority stake in Perex," *Pravo*, April 13, 1995.

¹⁸⁴ Nicholson, "Sharks'..."

¹⁸⁵ Interviews with Respondents #36 and 38

¹⁸⁶ "Last ŠtB chief Lorenc given 15 months suspended sentence," *CTK Daily News*, December 5, 2001.

¹⁸⁷ Interview and communication with Respondent #55, 2007 and 2014.

Some suspect that the young Penta founders may have gotten their seed capital thanks to help from influential ex-communist patrons like Lexa and Lorenc. “Their ‘story,’” says one source, “is that they started out importing shoes from China at age 23, which is complete bullshit. Behind Penta were Lexa, Lorenc, and other Lorenc associates from the ŠtB.”¹⁸⁸

Whether or not Penta emerged with the backing of such shadowy figures, Haščák and the other official founders of the group were already being groomed before 1989 to become part the future communist elite. Several had studied at the prestigious Moscow State Institute of International Relations. All were selected for training at Banská Štiavnica as part of a program across the eastern bloc to create a new generation of communist leaders.¹⁸⁹ That they should have emerged at the top of the post-communist elite should thus come as no surprise.

How did it happen? In 1997, Penta, a hitherto unknown brokerage, managed to persuade state financial institutions Slovenská Poistovňa (SP) and Slovenská sporiteľňa (SLSP) to finance its takeover of the country’s largest privatization fund, VÚB Kupon, which at the time had assets approaching Sk7 billion. Despite having only Sk48 million in basic capital (which they claim was the product of clever trading on the Bratislava Stock Exchange), they received an Sk350 million loan from SLSP along with two additional loans of Sk500 million each from SP. SP even allowed them to extend repayment of Sk250 million, without any collateral, at a full 13 percent below the going interest rate of 28 percent, and without any late penalties. Did SP have any business making such a loan at all? “No, they shouldn’t have,” admitted Haščák. “But on that occasion, they lent the money.” By 1999, the group had increased its net worth 200-fold.¹⁹⁰

The notion that a little brokerage could have obtained billions of crowns in financing on an arms-length basis strains credulity, to say the least. Both financial houses that financed the VÚB takeover were controlled by the HZDS, which itself had close ties to Vladimír Lexa. “How, after all, with so little financial backing or proven track record,” Nicholson asks, “had they managed to convince state managers to lend them sometimes unsecured funding during the deepest and darkest year of the Vladimír Mečiar government’s reign? The answer many came to was that Penta was a front for Mečiar government business interests.”¹⁹¹ True or not, the deals certainly had the appearance of politically-engineered soft loans that Penta otherwise would not have been able to get under a regime of sound banking supervision. (After the takeover, Jozef Oravkin, another plutocrat on our list and the former head of VÚB Invest, which administered VÚB Kupon, became a 10-percent shareholder in Penta.)¹⁹²

Leaving aside the financing behind the deal, the methods used in the actual takeover were, if not technically illegal, certainly suspicious. In obtaining control of VÚB-Kupon, Penta was exploiting a legal loophole that enabled a five-percent shareholder of an investment fund to exercise managerial control. At the time, in 1997,

¹⁸⁸ Interview with source.

¹⁸⁹ Nicholson, “The Technocrat.”

¹⁹⁰ Nicholson, “Penta Group: Jumps, Not Steps.”

¹⁹¹ Ibid.

¹⁹² Nicholson, “Who are the richest Slovaks?”; Tom Nicholson, “PENTA: People Remember,” *Slovak Spectator*, 7 July 2008.

VÚB-Kupon had hundreds of thousands of small shareholders who had exchanged their vouchers for shares in the fund. Once in control, Penta transformed it into a conventional joint-stock company, enabling it to skirt state regulations designed to protect the rights of minority shareholders. It then split the company into two parts, Intermark and Istrofin. Penta stashed all of VÚB-Kupon's valuable stock holdings in blue-chip companies into Intermark, leaving Istrofin with the junk. Naturally, Penta kept Intermark for itself and gave Istrofin to the fund's 160,000-odd small shareholders. It ultimately sold Istrofin to Istrokapitál, and we will see in due course the highly questionable way in which Istrokapitál disposed of the fund's assets, leaving minority shareholders with nothing.¹⁹³

As for Intermark, Penta utilized its control of the fund's minority shareholdings in blue-chip companies to wrest huge financial concessions from their majority owners. (Because the law at the time prevented an IPF from owning more than 10 percent of a given company, the stakes Penta inherited in the various companies after taking over VÚB Kupon were all minority shareholdings.) It did so by forcing the majority shareholders to either sell out to Penta at a low price or buy it out at a high price. As an incentive, Penta used the threat of years of lawsuits in Slovakia's abysmally slow and murky legal system.¹⁹⁴ Essentially, the group would go to a friendly judge and complain that the company's majority shareholder was acting contrary to the interests of minority shareholders. The judge would then issue an injunction on the grounds of an ongoing legal dispute between shareholders, a dispute which Penta itself had manufactured in the first place. The injunction prevented the majority shareholder from using its shares as collateral to obtain bank financing or selling its stake to someone else. "And so the majority shareholder is in a funny position," says one source. "What does he do? You can either wait it out and not be able to use what you have, or you can pay Penta an exorbitant amount for their small stake in the company. Or they'll simply take *you* over." The active assistance of an agent of force was essential to the success of such schemes. "They use the same judge and the same tactics over and over again, and nobody can do anything to fight it." The reason they were able to rely on the same judge each time was that, during the period when Penta was employing the strategy (1997-2001), cases were not allocated to judges randomly, as they are now. Instead, the chairman of each district court could decide which case to give to which judge.¹⁹⁵

In some cases, the majority shareholder that found itself battling Penta was the state. In other instances, it was a private owner. At least one of the latter cases amounted to a raid. Istrofin, controlled by Penta, found itself in a battle for control of Chemolak, a chemicals manufacturer, with the largest shareholder, Harvard Funds, owned by fellow plutocrat Juraj Široký.¹⁹⁶ In October 1998, just before a special shareholders meeting was to take place to elect a new Supervisory Board and Board of Directors, Istrofin obtained a court order suspending Harvard's voting rights in the company. Harvard responded by canceling the upcoming meeting, only to have Istrofin call another. Harvard tried to prevent the meeting from taking place by locking the doors to the building normally used for such purposes, but Istrofin simply convened it outside on the building steps. At the meeting, Istrofin ousted all of the management and supervisory

¹⁹³ Interview with source; Nicholson, "Penta Group: Jumps, Not Steps."

¹⁹⁴ Ibid.

¹⁹⁵ Interviews with source, 2007 and 2014

¹⁹⁶ Plutocratic Raid #1

board and changed Chemolak's statutes to require an 80 percent quorum in order to introduce major changes at the company. Chemolak claimed the meeting was illegal as the Commercial Code required 30 days to pass between the time a special shareholders meeting is called and the time it is convened. In the end, Penta settled for a payoff from Široký for Istrofin's stake.¹⁹⁷

Other companies Penta acquired during this period were Drôtovňa, a wire manufacturer (1998), and Novoker, a tile maker (1999).¹⁹⁸ However, I could not definitively confirm that these constituted raids.

More obvious examples of raiding were a number of "artificial bankruptcies," a favorite takeover tactic of Penta over the ensuing years. Its typical partner in these schemes was the sinister Zoroslav Kollár, the preeminent bankruptcy specialist of the plutocratic elite whom we will examine in great detail shortly. In the 1990s, the big three state banks had accumulated Sk130 billion in bad loans owed by various companies, many of which still had attractive assets. Under the first Dzurinda government (1998-2002), the non-performing loans were carved out of the state banks and transferred to a handful of state-backed "hospital banks" such as Slovenská Konsolidačná. Slovenská Konsolidačná would then sell off the loans as receivables to whomever wanted them. "So you have, say, a package of 32 billion crowns in loans that are non-performing, bought by Penta for 750 million," one source explains. "Then what they do is they divide those non-performing loans into two, because you need two creditors to declare bankruptcy, and then they have bankruptcy declared on a target firm. The target firm of course still has assets. So, they [Penta] don't get the loans back, but they do get the assets of the companies which didn't pay those loans. In some cases, those were significant assets. And they bought all this for a fraction of the price." Accomplishing this required not only good political connections at the hospital bank but also "bankruptcy trustees who are in the game, who will allow you to take the assets for a ridiculously low price. And you need a bankruptcy court judge who will appoint your trustee out of rotation order. So it's using loopholes in the law; it's using judges and trustees who are working for you."¹⁹⁹

One company that Penta acquired in this manner was Považské strojárne, a major weapons manufacturer.²⁰⁰ In this raid, Penta used Kollár to help take control of the company's assets. Having acquired a debt that the company owed, they managed to get the bankruptcy trustee to appoint their representative as the manager of the firm. They then proceeded to strip it of assets.²⁰¹ In 2009, Tom Nicholson obtained leaked files allegedly containing data from a wiretapping investigation by the SIS. Dubbed the "Gorila files," they hold a mountain of yet-to-be-confirmed evidence of corruption under the second Dzurinda government, from 2002 to 2006. Among the major protagonists in

¹⁹⁷ Tom Nicholson, "Fight for paints-maker turns nasty," *Slovak Spectator*, 2 November 1998 (<http://spectator.sme.sk/articles/view/6139/3/>). Interview with Respondent #47, 2014.

¹⁹⁸ Peter Kremšký, "Drôtovňa Holding skrachovala," *Trend*, 5 September 2001; Juraj Hruz, "Pokus o zmier," *Trend*, 31 January 2001.

¹⁹⁹ Interview with source

²⁰⁰ PR #2

²⁰¹ Interview with source

the files, which center around fraudulent public tenders and privatizations, is Penta, which was referred to as “the fifth coalition partner” in Dzurinda’s second government.²⁰² One of the scandals revealed in the data trove was an alleged arrangement between Penta and the head of the National Property Fund (FNM), Anna Bubeníková. According to the files, Penta allegedly offered her Sk200 million to represent its interests at the FNM during Dzurinda’s second term. Penta apparently tried to make the bribe appear as a legitimate business transaction by purchasing fictitious real estate assets from her along with an industrial hall that, in actuality, had no value. To replace the worthless industrial hall, they transferred to Bubeníková’s husband another venue that did have value. The latter hall was formerly owned by Považské strojárne, the company noted above. Her husband then sold the hall for Sk70 million. It later emerged that Bubeníková was actually a front for Kollár; the Sk70 million ended up going directly to him.²⁰³ In other words, if accurate, the files suggest that Penta paid Kollár for unspecified services by indirectly transferring to him an asset seized from the bankrupt Považské strojárne.

In another takeover, Penta managed to finagle the most valuable assets out of AG Banka, a Nitra-based bank that found itself in bankruptcy in 2001.²⁰⁴ The bankruptcy trustee sold the assets, nominally worth Sk883.1 million, to a Cypriot company for ten percent of their value. The Cypriot firm then “hired” Penta to collect the claims. It was not too long before Penta had already collected over half the Sk883.1 million. This more than made up for the relative pittance the Cypriot company had paid for them to begin with. Penta claims that everything was done above board; the sale of the assets to the Cypriot firm, it says, was transparent while the subsequent contract between the firm and Penta was concluded on an arms-length basis. Nevertheless, the manner in which the bankruptcy occurred raised suspicions. In particular, the bankruptcy trustee approved the asset sale without consulting the other creditors and without an expert valuation of the assets by a court expert, as is required under Slovak law.²⁰⁵

In addition to raids, Penta has also benefited from privatizations that were, if anything, highly questionable. We have already noted the state companies that Ivan Lexa sold to his father, Vladimír, while he was in charge of the Slovak privatization process. A decade later, in 2002, Penta was suspected of privatizing the state shipping company, Slovenská plavba and prístavy (SPAP), at a price well below its true value. Three of the companies that participated in the tender were connected to Penta, including Penta Investments, Emteco, which had links to Penta, and the ultimate winner, a previously unknown firm called Dunaj Servis, for which Penta provided “consulting services.”²⁰⁶ Other privatizations Penta won garnered accusations of corruption and violations of minority shareholder rights. Among these were Transpetrol (2001), VSZ (2002), and the Restitution and Investment Fund (2002).²⁰⁷ Another such privatization was the sale of the Bratislava airport in 2005-2006 to a consortium that included Penta. The consortium

²⁰² Tom Nicholson, *Gorila* (Bratislava: Vydavateľstvo Dixit, 2012). “Scandal in Slovakia: The multi-million euro gorilla,” *The Economist*, 27 January 2012.

²⁰³ Ibid.

²⁰⁴ PR #3

²⁰⁵ Rado Baťo, Jana Kováčová and Juraj Hruz, “Správca predal majetok AG Banky aj bez súhlasu veriteľov,” *Trend*, 5 September 2001; “Penta získala z pohľadávok AG Banky viac ako 160 mil. Sk,” *SITA*, 25 June 2001

²⁰⁶ “Investigation of corruption dwindles away – press,” *CTK Business News*, June 4, 2001.

²⁰⁷ Nicholson, “Penta Group: Jumps, Not Steps.”

won despite claims by one of the other bidders to have made a higher offer. The rules of the tender apparently underwent constant changes. In addition, the tender condition that there could be no connection between any two competitors was violated by the winning consortium.²⁰⁸

J&T

The story of J&T's rise is remarkably similar to that of Penta. Its name derives from the initials of its two "official" founders, Ivan Jakobovič and Patrik Tkáč, who set up the brokerage in 1994. The group eventually took on another partner, Peter Korbačka.²⁰⁹ But the main agent thought to be behind its success is Tkáč's father, Jozef, who would eventually come to own half its shares. Tkáč Sr. headed the state bank IRB from 1992 to 1996, during the era of HZDS dominance. It was allegedly thanks to "daddy's money," as one source put it, that the conglomerate really took off. "The J&T boys are meatheads, idiots. They are four levels below Penta in terms of sophistication."²¹⁰

Like Penta, however, the first major coup for J&T was the takeover of investment funds. In nearly identical fashion to Penta, J&T rose from a pint-sized brokerage to become the manager of two of the country's largest investment funds, Creditanstalt and Drôtovňa Hlohovec. The takeovers were financed by loans from IRB. Asked whether the financing was secured as a result of his father's position at the bank, the younger Tkáč admitted that "He certainly played a key role. Wherever Jakobovič and I went, they thought that old Tkáč was behind it. His name opened doors for us, not just at other banks but at IRB itself. It allowed us to borrow enough money to do some large transactions."²¹¹ Another J&T partner, Martin Fedor, confirms the essential role of familial ties in the group's success. "You can imagine how important [the family connection] was for a couple of guys starting a company, maybe 21 or 22 and still in university, without any kind of academic title, all of which often made it very difficult to get in to talk to the director of a company about an investment." After authorizing the loans to J&T, Tkáč Sr. left IRB, which was rapidly sinking at the time due to non-performing loans extended under his watch, to become the group's President.²¹²

If J&T acquired the money for the purchases by means of soft loans, the prices they paid for the IPFs themselves were far below the market value. In the case of Creditanstalt, J&T managed to buy a controlling stake of 25.84 percent in October 1996 for Sk940 per share, a pittance compared to the Sk4135 the fund's shares were trading for on the Bratislava Stock Exchange. "This was a friendly takeover. They wanted to sell," explained Fedor. Afterward, J&T transformed the fund into a joint-stock company, which allowed it to skirt legal protections for minority shareholders. It then called a series of shareholders meetings, for the most part attended only by those linked to J&T rather than the other 45,000 small shareholders. At the meetings, J&T not only changed the fund's supervisory board but, in a move clearly at odds with existing law, replaced

²⁰⁸ Mandy Kirby, "Immunity Lifted from Slovak Deputy for Bribery Allegations Investigation." *WMRC Daily Analysis*, November 28, 2003; Interview with Respondent #37.

²⁰⁹ Nicholson, "Who are the richest Slovaks?"

²¹⁰ Interview with source

²¹¹ Tom Nicholson, "J&T: From broker to banker," *Slovak Spectator*, 7 July 2008; Nicholson, "Sharks'..."

²¹² Nicholson, "J&T: Access to Funds, Privatization Chances Make Millionaires of College Students."

the board of directors as well. Given that the decisions made at such meetings required approval by a judge, an agent of force, they very likely constituted raids.²¹³

Following the takeovers, J&T, like Penta, was able to translate its growing wealth into political influence, obtaining access to additional soft budget constraints that further expanded its holdings. In the late 1990s, the group collaborated with Penta in a number of highly questionable privatizations including the sale of the VSŽ steel mill, Transpetrol, the Restitution and Investment Fund, and shipping firm SPaP.²¹⁴

Later on, J&T forged especially close ties to the governments of Róbert Fico. Martin Fedor, one of the partners in J&T, is the son-in-law of Dušan Muňko, the former Deputy Environment Minister affiliated with Fico's party, Smer-SD. Another J&T representative, Róbert Hančák, headed the economic department of the Interior Ministry when the latter was led by Smer-appointee Róbert Kaliňák.²¹⁵

Istrokapitál

In addition to Penta and J&T, Istrokapitál is the third of the big-three financial groups that scored its first major business success through the dismantling of the investment funds. Even compared to the other two, it has a particularly nefarious reputation. "Everybody in the business world is very, very careful when dealing with Istrokapitál," said one source.²¹⁶ According to a 2009 article in *The Times* of London, "Istrokapitál has been described as a conduit for 'Russian money' and a front for money laundering. In written evidence to the [UK] Foreign Affairs Select Committee last year, Istrokapitál was described as having the 'strongest ties to the underworld and is known to draw its muscle from former officers of the Slovak intelligence service'."²¹⁷ Most notably, the group ended up hiring the thugs who had been responsible for the kidnapping of the President's son, an incident in which the role of former SIS-head Ivan Lexa is well-documented.²¹⁸ "Istrokapitál," says another source, "is the most criminal organization out of the three," allegedly having close ties to the Takáč organized crime group as well as former intelligence operatives ousted from the SIS after Lexa's departure.²¹⁹

The question of how Mario Hoffman, Branislav Prieložný, Anton Siekel, and Radovan Vítek, who became the main principals of Istrokapitál, obtained their seed capital is the subject of some speculation. Hoffman claims that a portion came from savings he accumulated working in a casino while most of it was "borrowed from my family members abroad." The only problem with his account is that, according to those who have investigated the matter, Hoffman had no relatives who had the money to lend

²¹³ PR #4

²¹⁴ Nicholson, "Penta Group: Jumps, Not Steps."; Nicholson, "J&T: Access to Funds, Privatization Chances Make Millionaires of College Students."

²¹⁵ Nicholson, "Sharks'..."

²¹⁶ Author's Interview with Respondent #36

²¹⁷ Róbert Smith, "Property developer Mario Hoffman said he 'owned' Turks and Caicos government," *The Times*, 13 February 2009

²¹⁸ Rosenberger, "Big Brother in a Small Country: The Subversion of the Rule of Law in Contemporary Slovakia," 34.

²¹⁹ Interview with source

him in the first place. “It’s total bullshit,” says my source, “but that’s their story and they’re sticking to it.”²²⁰

Setting the stage for their eventual success was their appointment to manage three investment funds that had been established by state companies. The partners’ initial plan had been to purchase stakes in the funds and then sell them on at a profit to Cassovia Invest, the funds’ administrator at the time. When Cassovia refused to oblige, a war ensued that ended in 1995 with the acquisition of three of the funds by the future Istrokapitál principals. Later that year, Slovenská Poistovňa (SP), an investment firm that was majority-owned by the state, merged four of its investment funds into a single holding called Istrokapitál. At the time, Istrokapitál had nothing to do with Hoffman, Siekel, Prieložný, or Vítek. That would soon change. In the summer of 1996, a battle for control of SP erupted between the three parties in the ruling coalition. In the end, the HZDS was able to oust the Slovak National Party’s representatives from the investment house. In October, the new HZDS-appointed head of SP sold a 35 percent stake in Istrokapitál Investment Fund on the stock exchange to two companies, Prominent Holding and BMI Securities. Both firms shared the same address as well as ties to Prieložný. They managed to buy the controlling stake in Istrokapitál for a mere Sk79.5 million despite the fact that a recent internal SP audit had valued it at Sk250 million. Given that SP had originally acquired the shares for Sk169 million, the privatization resulted in a substantial loss for the state company. In the end, the new owners eventually sold the stake for Sk320 million. The question of how Prieložný, Siekel, Hoffman, and Vítek managed to convince the SP leadership to sell Istrokapitál remains unanswered,” Nicholson notes.²²¹ Since that time, Istrokapitál has become the main holding company of the four partners.

In addition to the funds mentioned above, Istrokapitál also gained control of Istrofin, the other half of VÚB-Kupon that Penta had established in 1997 after transforming the investment fund into a joint-stock company. As noted earlier, Istrofin held the stakes of most of the 160,000 small shareholders in VÚB-Kupon. Upon acquiring managerial control of Istrofin, “Istrokapitál gave it to Kollár to take care of and Kollár did this whole bankruptcy bullshit. He declared a fake bankruptcy on it, satisfied two or three large creditors which were his own companies, and disallowed all the claims of the minority shareholders, who got nothing. End of story. And these guys, Istrokapitál, said to him, ‘Look, we’ll give you 10 million crowns if you take care of it for us.’ He knows all the ins and outs and ‘did what had to be done’.”²²² This was a classic criminal corporate raid, executed by businessmen who allegedly obtained their initial capital thanks to soft budget constraints - namely the underpriced stock exchange purchase of the Istrokapitál fund.²²³

The group continued to grow over time thanks to continued soft budget constraints as well as raiding. All the while, the “incestuous relations” between Istrokapitál, Penta, and J&T took on new and expanded forms. In late 2001, a 21 percent stake in steelmaker VSZ held by state-owned Transpetrol was offered for sale on the stock exchange for Sk177 per share. This was far less than the Sk222 the shares were

²²⁰ Interviews with source

²²¹ Nicholson, "Istrokapital: Insurance Aids ‘Family’ Brokerage."

²²² Interview with source

²²³ PR #5

trading for at the time. The buyer was Stredoeurópsky maklérsky dom (SMD), a firm linked to Istrokapitál. SMD immediately turned around and sold the shares, at no profit, to Poštová banka, which subsequently sold them to Penta and J&T. “The deal,” writes Nicholson, “was attacked for being untransparent, for involving share price manipulation, and for having cost the state money with the apparent approval of Economy Minister Ľubomír Harach and Deputy PM Ivan Mikloš.”²²⁴

In another example, Dunajservis, the vehicle Penta and Istrokapitál used to participate in the privatization of shipping firm SPaP, was part-owned by another company that shared the same name and address as a mill owned by Vladimír Lexa, the ex-communist alleged to be one of the main backers of Penta. Dunajservis, meanwhile, is part-owned by Gammapolis, which listed as one of its directors Martin Lieskovský. Lieskovský was among those charged but later pardoned for the 1995 kidnapping of Michal Kováč Jr., the President’s son.²²⁵

This is only the tip of the iceberg when it comes to business ties between Istrokapitál’s partners and alleged underworld figures. Among these reputed criminal connections are two other men accused in the kidnapping of Kováč Jr., former SIS officers Ľuboš Kočík and Michal Hrbáček. Hrbáček was initially jailed for his role in the crime but he too was later released under Mečiar’s amnesty.²²⁶ Hrbáček headed the Special Executive Unit (OŠO) of the SIS under Ivan Lexa. According to allegations, he trained the four agents who forcibly removed the President’s son from his car and made him drink himself unconscious before dumping him on an Austrian roadside. In addition to the Kováč Jr. kidnapping, Hrbáček was also suspected of siphoning weapons from the SIS; indeed, he is cited in Mitro’s report as the “main actor” in the theft of SIS weapons.²²⁷

An expert in judo, Hrbáček began his career in the early 1990s providing security to politicians and businesses in Bratislava. He was later chosen by Lexa to head the OSO. “As the boss of the OŠO, Hrbáček had virtual carte blanche – he and his men were assigned the service’s dirtiest, darkest roles, with no one looking too closely at how they carried them out,” Nicholson writes. Mitro’s report also accuses him of taking part in actions against the opposition and also describes his “contacts with people from the organized crime environment.” In particular, between 2000 and 2003 he held positions in eight companies alongside Tomáš Bajtoš, whose BOB Security Firm is thought by police to be “one of the pillars of the Takáč organized crime group in Bratislava,” according to Nicholson’s article.²²⁸

Asked about the group’s relationships with such notorious figures, Istrokapitál executive Miroslav Remeta helpfully clarified the matter: “Overall, I would say that what we have here is a case of the skillful business activities of former SIS people.”²²⁹

²²⁴ Nicholson, "Istrokapital: Insurance Aids ‘Family’ Brokerage."; Nicholson, "Penta Group: Jumps, Not Steps."

²²⁵ Nicholson, "Istrokapital: Insurance Aids ‘Family’ Brokerage."; Nicholson, "Penta Group: Jumps, Not Steps."

²²⁶ Nicholson, "Civilian oversight of police..."

²²⁷ Nicholson, "Pride came before fall."

²²⁸ Nicholson, "Pride came before fall."

²²⁹ Nicholson, "Istrokapital: Insurance Aids ‘Family’ Brokerage." Tom Nicholson, "Hrbáček released from custody," *Slovak Spectator*, 12 January 2009

Others suggest their value to Istrokapitál went well beyond business acumen, which very likely did not exist in the first place. “For years, Hrbáček worked as a ‘hired gun’ for corporate raider Istrokapitál, especially for co-founder Branislav Prieložný, allegedly helping to convince business ‘partners’ to forfeit their stakes.”²³⁰ Based on the testimony of a former policeman and partner of Hrbáček, police arrested him in September 2008 for allegedly orchestrating “dozens of beatings of entrepreneurs and other targets for profit...carried out by clandestine commando units made up of former and serving police officers.” Summing up Hrbáček’s career, Nicholson concludes:

For a decade, Michal Hrbáček was one of Slovakia’s worst-kept secrets. He was rumored to have masterminded the brutal takeovers of companies like Slovglass and Chirana, to have orchestrated the kidnapping of the President’s son, and to have provided muscle for corporate raiders Istrokapitál. He was credited with vast power, connections and ruthlessness. He was untouchable, but no one was safe from him. “Be careful,” said a former police anti-corruption unit chief...after an interview was over. “He’s the kind of guy who shoots first and asks questions later.”²³¹

Allegations began to mount after the November 2006 home invasion and murder of businessman Ján Kubašiak, allegedly executed by Hrbáček and two others. The killing sparked a wide-ranging police investigation of criminal activities among its own officers. As of 2008 the inquiry had identified upwards of 140 violent crimes allegedly committed by police rank-and-file, ranging from home invasions to extortion, kidnappings, and robberies. Hrbáček was allegedly a central figure in some of these crimes.²³²

Another incident unearthed by the police investigation was an alleged criminal corporate raid on the Perspektíva insurance house, which was in bankruptcy.²³³ Hrbáček and others allegedly administered a beating on the bankruptcy trustee to intimidate him into selling the company’s receivables for trivial sums. It apparently worked; shortly afterward, the trustee sold nearly Sk240 million of Perspektíva receivables, many of which were owed by Istrokapitál, for Sk1.1 million to a Seychelles firm. The source of this information is Juraj Rozsík, the alleged accomplice of Hrbáček who is serving an 8.5 year sentence for his part in the murder of Ján Kubašiak, who was thought to be a “white horse” in the heating oil tax scam. Since Rozsík began cooperating with authorities, he has complained of constant attempts to harass and intimidate him, including from a lawyer who visited him in prison (“Aren’t you afraid for your life and your family when you walk out of here?” the lawyer asked).²³⁴ He also received a copy of the bible from an unknown source, “which may mean he should begin praying,” reported Prosecutor General Dobroslav Trnka. In August 2008, Rozsík barely escaped harm when a car transporting him from prison to a court detention cell had to flee from another vehicle

²³⁰ Nicholson, “Pride came before fall.”

²³¹ Tom Nicholson, “Phone call lands former SIS officer in hot water,” *Slovak Spectator*, 20 October 2008.

²³² Ibid.; Luba Lesná, “Informant exposes police ties to underworld,” *Slovak Spectator*, 22 September 2008)

²³³ PR #6

²³⁴ Nicholson, “Phone call lands...; Lesná, “Informant exposes police ties...; “Slovak ex-policeman may face life sentence for murder.”

reportedly driven by rival criminals.²³⁵ It was for allegedly trying to intimidate and assault Rozsík and others testifying against him that Hrbáček was arrested in 2008.

Another raid in which Rozsík implicated Hrbáček as well as Lieskovský and another former SIS officer, Miroslav Jacko, targeted Slovglass.²³⁶ All four individuals, including Rozsík, ended up on the company's board following the alleged raid.²³⁷ "The name Hrbáček in particular has since been associated with strong-arm tactics in the business world, such as the takeover of Slovglass in 2005 with the help of a private security firms and Messrs. Lieskovský and Ján Čarnogurský Jr., son of the former justice minister."²³⁸ Hrbáček, who allegedly engineered the kidnapping of Kováč, Jr., has been involved in business with Ján Čarnogurský, Sr. and his son. The elder Čarnogurský's was the leader of the anti-Mečiar opposition at the time of the kidnapping and the main protagonist in the campaign to punish those responsible. The irony in this has apparently been lost upon the three business partners.²³⁹

According to my sources, there was a division of labor in the Slovglass raid between the thuggish Hrbáček and Jacko, on the one hand, and the legally refined Čarnogurský, Jr., on the other. Hrbáček and Jacko allegedly entered the premises, kicked out the existing security team, and replaced it with their own. Meanwhile, Čarnogurský, Jr. handled the legal niceties of changing the company's management in the courts. The management change proved a challenge given that the raiders owned only one percent of the company at the time. But the involvement of Hrbáček was reportedly enough to make the police let the matter rest.²⁴⁰

Hrbáček, Lieskovský, and other associates reportedly also assisted Istrokapítal in its efforts to take control of private companies through illegally-convened shareholders meetings. The particular method they allegedly used was known as the "parking-lot EGM" (EGM stands for "extraordinary general meeting"). Individuals representing minority shareholders would call an EGM and subsequently prevent the majority shareholder from attending, thereby giving the raiders a majority of those present. They would then alter the company's statutes to reduce to an acceptable level the minimum percentage of shareholders whose votes must be obtained to change the management. This allowed the raiders to put themselves in control of the firm, opening the way to transfer all its assets out within 24 hours. Any such changes to a company's management requires the authorization of an agent of force and in particular a judge. According to one of my sources, "Either they have somebody within the shareholder group who is willing to cooperate with them...I mean, you know, these things have never washed out in the courts, so it's not certain how they took over these companies. But there were a lot of complaints of these shaven-headed thugs walking in and preventing other shareholders from attending the meeting – various accusations like that. And there are a number of companies that later fell under their wing."²⁴¹ Slovglass was one of the companies Hrbáček and his associates allegedly seized by means of a parking-lot EGM. Rumors

²³⁵ Lesná, "Informant exposes police ties..."

²³⁶ PR #7

²³⁷ Nicholson, "Phone call lands..." Tom Nicholson, "Police bust kidnap gang in their midst." *Slovak Spectator*, 30 April 2007.

²³⁸ Nicholson, "Civilian oversight..."

²³⁹ Nicholson, "Pride came before fall."

²⁴⁰ Interviews with source and Respondent #55

²⁴¹ Interview with source

also surround a 2004 raid on another company, Skloobal, which was reportedly done on behalf of Istrokapitál.²⁴² (Skloobal had earlier been one of the companies sold in the “midnight privatizations” held in early 1994 during the final days of Mečiar’s second government.)²⁴³

Along with Hrbáček and members of the Čarnogurský family, Istrokapitál was allegedly involved in a 2006 raid against Rašelina Quido, a peat producer.²⁴⁴ The raiders reportedly arranged two legal cases - one civil and one criminal - that simultaneously targeted Rašelina and its owner, Tobiáš Loyka. In the civil case, Čarnogurský, Sr. accompanied Hrbáček to court. Both were acting on behalf of the plaintiff, Prominent Holding, and were there to enforce a disputed claim against Rašelina.²⁴⁵ The criminal case against Loyka was allegedly arranged by Vladimír Palko, Interior Minister in the “reformist” Dzurinda government, working in cooperation with Hrbáček and Istrokapitál. According to my source, Palko had his police officers frame Loyka for attempting to orchestrate the murder of Gabriela Matušková and the kidnapping of Istrokapitál co-owner Branislav Prieložný. Loyka was jailed but then released due to a lack of evidence. However, three months later he was jailed again, this time on the basis of fake documents containing his forged signature.²⁴⁶

Another bankruptcy-related raid that reportedly involved Istrokapitál targeted Hydrostav, a construction firm, in 2002. Despite the fact that Hydrostav had Sk1.2 billion in debt, Istrokapitál was able to transfer some of the firm’s receivables to companies it controlled, leaving the construction company in bankruptcy.²⁴⁷

Hrbáček and Čarnogurský reportedly applied similar tactics in the acquisition of medical equipment maker Chirana-Prema in 2003,²⁴⁸ although in that case they were allegedly acting on their own behalf, not Istrokapitál. According to my source, Hrbáček and his associates paid a visit to the owners and issued threats while Čarnogurský came up with the legal pretext to take over the firm. Hrbáček put 90 percent of the shares in his own name while the other 10 percent went to a former SIS colleague. They later sold the company in 2007.²⁴⁹ Hrbáček has allegedly been engaged in criminal activity more recently too, even with the charges against him winding their way through the judicial system. In particular was his reported involvement in the so-called “estate mafia” alongside Ľubomír Kudlička, head of the Takáč organized crime gang. The scheme consisted of expropriating land from private individuals.²⁵⁰

After rising to the top of the Slovak business world on the back of soft budget constraints and raiding, Istrokapitál went bankrupt in 2012 after suffering losses on investments in Greek bonds. In exchange for bailing it out, J&T ended up with an 88 percent stake in Istrokapitál’s Poštová Banka.²⁵¹ Evidently, Hoffman, Prieložný, and

²⁴² Interview with source; Nicholson, “Phone call lands...;” Nicholson, “Police bust kidnap gang...”

²⁴³ King, “Ex-Slovak Regime...”

²⁴⁴ PR #8

²⁴⁵ Nicholson, “Pride came before fall.”

²⁴⁶ Interviews with Respondent #55, Interview with source.

²⁴⁷ Nicholson, “Istrokapital: Insurance Aids ‘Family’ Brokerage.”

²⁴⁸ NPR #16

²⁴⁹ Interview with source

²⁵⁰ “Kauza pozemkovej mafie: Obvinili šéfa skupiny takáčovcov Kudličku,” *Nový Čas*, 15 March 2012; Tom Nicholson, “Pozemková mafia kradla potichu,” *SME*, 3 May 2010.

²⁵¹ “NBS OKs the increase in J&T’s interest in Poštová Banka” *Slovak Spectator*, 24 September 2012

Siegel should have stuck with what they knew - namely expropriation and theft - rather than dabbling into activities better suited to actual entrepreneurs.

Other Political Thugs

Neither Penta nor Istrokapítál could have pulled off the artificial bankruptcies they did without the help of another political thug on our list of plutocrats, Zoroslav Kollár. Originally a commercial lawyer, he made his initial fortune by means of such bankruptcies and in later years would continue to employ the strategy to great effect. Allegedly collaborating with the current defense minister, Martin Glváč, and the Sýkora organized crime group, Kollár's representatives would pretend to deposit cash into the target company's bank account, thereby creating a fictitious liability owed by the firm. They would then send a letter to the company demanding that the money be repaid by a certain date lest bankruptcy proceedings be initiated. In actuality, repayment of the debt was the last thing they wanted; indeed, the letter would neglect to contain either an account number or mailing address to which the money could be sent.

Rather than the debt itself, Kollár and his collaborators really sought control of company that owed it (or, more accurately, did not owe, as the debt never existed in the first place). Once the deadline for repayment was inevitably breached, the raiders would go to a bankruptcy judge who would in turn begin the bankruptcy process. The raiders allegedly had a number of judges and bankruptcy trustees they worked with. In some cases, Kollár and his associates implemented the scheme on behalf of clients like Istrokapítál and Penta; in other instances they took over the assets for themselves.²⁵² "It's a very effective way of putting property into your hands. And if they do it carefully, in other words so that you cannot prove that the receivables are bogus, then it is within the law. And of course they changed the law in 2004-2005 to plug this hole, but at the time it was a very valid practice."²⁵³

In 2004, the Justice Ministry under Daniel Lipšic began working with Jozef Šátek, the head of the police's Anti-Corruption Unit, to investigate the bankruptcy scams. Both the Bratislava and Banská Bystrica regional courts fell under suspicion by the investigators for their alleged role in the takeovers.²⁵⁴ Dozens of bankruptcies were investigated in all. One of the alleged victims was a company called Adria Škrob,²⁵⁵ whose debts were sold at a fraction of their value.²⁵⁶ The bankruptcy administrator in the case, Henrich Dušek, came under investigation for embezzlement. The inquiry also targeted other bankruptcies including Bratislavská cvernova továreň, a holding company, and Vinoprodukt, a wine producer, along with Istrofín, the part of VÚB-Kupon containing all the junk assets that Penta had sold to Istrokapítál.²⁵⁷

²⁵² Interviews with Respondent #42, Respondent #46, and another source.

²⁵³ Interview with Respondent #47

²⁵⁴ "No progress in investigation of suspicious bankruptcies – press," *CTK Daily News*, May 3, 2005.

²⁵⁵ PR #9

²⁵⁶ "Slovak police solving first case of 'bankruptcy mafia'," *CTK Daily News*, October 27, 2004.

²⁵⁷ "Bratislava Regional Court Declares Bratislavská Cvernova Tovaren Bankrupt," *Slovakian News Digest*, May 7, 2003; "Kurzový lístok Národnej banky Slovenská - Court Adjourns Hearing in Bankrupt Financial Firm Istrofín," *SITA*, June 15, 2004.

Another case, according to investigators, targeted Černovka, a thread manufacturer.²⁵⁸ Its product was worthless at the time but the company was situated on valuable real estate in the center of Bratislava. It was allegedly taken over by means of the same artificial bankruptcy methods described above.²⁵⁹ In February 2003, judge Alexander Mojs ruled that plywood maker Preglejka Žarnovica had been the victim of another artificial bankruptcy.²⁶⁰ He alleged that the bankruptcy trustee defrauded the company by illegally transferring its assets to individuals linked to Merkuria Bratislava. He was later removed from his position by a disciplinary court.²⁶¹ A search of the business register reveals the existence from 2000 onwards of Merkuria a.s. The owner of that company is a firm called Begram s.r.o. which, from 2005 onwards, lists as a partner and managing director one Zoroslav Kollár, residing at Nejedlého 51/3064 in Bratislava.²⁶²

During the investigation in 2004-05, Jozef Šátek, in full strutting-rooster mode, publicly and consistently railed against the so-called “bankruptcy mafia.” Then, one day, he suddenly shut up about it. Ultimately, only one person, a lawyer from Kollár’s office, was ever charged in connection with the scam. Tom Nicholson, the journalist who publicized the Gorila files, claims to have seen an SIS document alleging that Kollár paid Sk100 million into the right people’s accounts in order to have the investigation shelved. A conversation from the Gorila documents that reportedly involves Penta’s Jaroslav Haščák sheds light on what may have happened. Penta had allegedly worked with Kollár in some of the bankruptcies (mainly by purchasing receivables from the state hospital bank and then taking companies over through the bankruptcy process). When asked how close Šátek came to bringing the whole thing down, Haščák reportedly responded that he indeed came quite close. It was only after finding out about the course of the ongoing investigation from a police contact that Kollár began paying off the people he needed to in order to get the investigation dropped.²⁶³ The payments were made to various companies using white horses. “Kollár is the one who has the most to do with organized crime out of all these rich guys,” says one of my sources.²⁶⁴

Wealthy as he is, Michal Hrbáček, who allegedly assisted Istrokapitál in so many raids, is not rich enough to be a member of the plutocrats. However, Ivan Lexa, his former boss at the SIS, certainly is. While I have not found any raids in which he is directly implicated, he can definitely be classified as a political thug. The main source of his notoriety stems less from his role in business as it does from his dealings as part of the Mečiar cabal, first as head of privatization and later as chief of the SIS.

Under Lexa’s stewardship, there seemed to be no limit to the range of criminal activity to which the SIS availed itself. The intelligence agency was known for tailing opposition members, journalists, diplomats, visiting foreign missions from the EU and NATO, and organized crime figures. As noted earlier, the SIS did more than just follow

²⁵⁸ PR #10

²⁵⁹ Author’s Interview with source

²⁶⁰ PR #11

²⁶¹ “Bankruptcy Trustees Defrauded Plywood Maker,” *TASR*, February 6, 2003.

²⁶² “Merkuria a.s.,” Business Register of the Slovak Republic on Internet (<http://www.orsr.sk/vypis.asp?lan=en&ID=30544&SID=2&P=1>); “Begram s.r.o.,” Business Register of the Slovak Republic on Internet (<http://www.orsr.sk/vypis.asp?lan=en&ID=62780&SID=2&P=1>).

²⁶³ Interview with Tom Nicholson, 13 February 2014.

²⁶⁴ Interview with source

organized crime bosses around town; it actively supported, protected, and collaborated with them, most notably in the 1995 kidnapping of Kováč Jr., an operation run by Hrbáček but approved by Lexa.²⁶⁵ Others alleged that the agency commissioned organized crime groups to carry out murders, including of government opponents.²⁶⁶ To eliminate evidence of its cooperation with organized crime, some suspect, Lexa's SIS simply eliminated the criminals themselves.²⁶⁷

After the HZDS was ousted in 1998, Lexa absconded to South Africa but was eventually extradited back to Slovakia. Despite being charged on over a dozen counts including the Kováč Jr. kidnapping, he was acquitted of all but one: conspiring to discredit a Catholic bishop. The kidnapping, of course, was covered by Mečiar's amnesty.²⁶⁸ During his various trials, reports surfaced of witnesses and judges facing threats and intimidation.²⁶⁹ While it is difficult to prove that inappropriate influence was behind his acquittals, future Justice Minister Štefan Harabin ended up promoting all of the judges responsible for them.²⁷⁰ Lexa was also alleged to have used his position at the SIS to enrich himself, benefiting from multiple privatizations as well as the siphoning of weapons from the agency.²⁷¹ In December 2003, he was charged by the Special Prosecutor for ordering the murder of Róbert Remiáš in an attempt to cover up the Kováč kidnapping. But the charges in that case were dropped as well thanks to Mečiar's previous amnesty.²⁷²

Juraj Široký, another plutocrat and onetime business partner of Lexa, was a prominent official during the communist era, when he served as a captain in the ŠtB, the state intelligence agency. The same was true of a number of his business associates in and around the Harvard investment funds, including Branislav Králik and Josef Poštulka.²⁷³ He is a former classmate of Ivan Lexa as well as Jozef Brhel, another plutocrat.²⁷⁴ In an example of feedback effects, Široký would later parlay his growing wealth and influence into further soft budget constraints; according to a 2009 Wikileaks cable, a deal with Chinese developers to build highways fell through because a "sponsor" of the Fico government, later revealed as Široký, was concerned about losing a contract for the supply of concrete.²⁷⁵

²⁶⁵ Lesná, "Informant exposes police ties...; Green, "Extortion and Protection Rackets Grow...;" "Mafia hitmen hired for one million dollars – Pittner," CTK Business News, March 29, 1999; "Slovak secret service under previous cabinet had close mafia ties - Czech press," *BBC Monitoring European*, February 16, 1999.

²⁶⁶ "Slovak secret service under previous cabinet...;" Green, "Extortion and Protection Rackets Grow...;" 1998; Andrea Lorinczova, "Officials link Slovak intelligence to mafia in Mečiar regime." Associated Press Newswires, February 16, 1999.

²⁶⁷ Interview with Respondent #55

²⁶⁸ "Investigators name two in murder of a key witness in Kováč kidnapping," Associated Press Newswires, November 30, 1999; Lukas Diko, "A Lexa-con of Slovak Justice." Transitions Online, January 31, 2005.

²⁶⁹ Diko, "A Lexa-con...;" "Lipsic Promises Protection for Judge Whose Car Was Set on Fire," SITA, April 17, 2003.

²⁷⁰ Interview with Respondent #48

²⁷¹ "Opposition paper hints SIS head involved in sleaze affair."

²⁷² "Ex-spy boss Lexa wins lawsuit against Slovakia," *Slovak Spectator*, 23 September 2008 (http://spectator.sme.sk/articles/view/33020/10/ex_spy_boss_lexa_wins_lawsuit_against_slovakia.html).

²⁷³ "The spy who prospered," *Slovak Spectator*, 30 November 2009

²⁷⁴ Interview with source

²⁷⁵ "Slovak media laps up new WikiLeaks," *Slovak Spectator*, 12 September 2011 (http://spectator.sme.sk/articles/view/43829/2/slovak_media_laps_up_new_wikileaks.html).

The Harvard funds were the main beneficiary of the Mečiar government's raids on two mutual funds, PSIS and PSIPS. During the voucher privatizations, many voucher holders placed their vouchers with mutual funds such as PSIS and PSIPS, which invested them on customers' behalf. Given that these shareholdings belonged to others instead of his HZDS cronies, Mečiar was naturally displeased with the whole arrangement. That the privatizations had already taken place and the companies had new owners mattered little to him; he and his representatives moved to expropriate them anyway.

PSIPS was the first to come on the HZDS chopping block.²⁷⁶ In September 1994 the Finance Ministry, led by HZDS-appointee Jozef Magula, placed the fund under forced administration, albeit promising compensation to the thousands of share owners. In March of 1995, the ministry withdrew its license.²⁷⁷ A meeting of the fund's 74,000 shareholders that took place shortly afterward descended into violence; shareholders who had not received the promised compensation attacked a lawyer after she informed them that the meeting had failed to meet a quorum.²⁷⁸ Simultaneously, the investigation department of the regional government of Banská Bystrica accused the fund's chairman and owner, Miroslav Nakládal, of conducting illegal business activities.²⁷⁹ Later that year, the Supreme Court ruled that the revocation of the fund's license by the ministry was illegal, but no matter; Magula simply put the fund under forced administration once again and appointed Harvard Investment Company, owned by Široký and his associates, as the fund's administrator.²⁸⁰ All the while, the ministry claimed to be acting to protect the property of the fund's shareholders - that is, the very people whose property it was expropriating.²⁸¹

In addition to PSIPS, Magula's Finance Ministry also raided PSIS that same year.²⁸² In April 1995, it stripped the fund of its operating license, accusing it of various irregularities. In response, the fund appealed to the Supreme Court, which ruled in its favor. Not only did the reasons the ministry cited for revoking the license hold no validity under existing laws, they were not even factual, the court found.²⁸³ As with PSIPS, the ministry claimed it was acting on behalf of shareholders who saw the value of their shares destroyed as a direct result its actions.²⁸⁴ In another similarity to the PSIPS raid, the ministry completely ignored a Supreme Court decision invalidating the revocation of the fund's license and proceeded to revoke it again.²⁸⁵

²⁷⁶ PR #12

²⁷⁷ "PSIPS Fund fighting forced administration a second time," *CTK Business News*, April 29, 1996; "Harvard Investicna sells IRB shares," *CTK Business News*, August 7, 1996; "Slovak ministry to liquidate privatisation fund," *Reuters News*, March 10, 1995.

²⁷⁸ "PSIPS EGM ends in violence," *Hospodárske noviny*, March 24, 1995.

²⁷⁹ "PSIPS chair accused of criminal activity," *CTK Business News*, June 13, 1995; "PSIPS chair sold off holdings to brother - press," *CTK Business News*, May 12, 1995.

²⁸⁰ "PSIPS Fund fighting forced administration..."; "Harvard Investicna sells..."; "Slovak ministry to liquidated..."

²⁸¹ "PSIPS investment fund considers finance ministry's steps illegal," *TASR*, March 28, 1996.

²⁸² PR #13

²⁸³ Peter Javurec, "FOCUS - Slovak court ruling seen helping equity mkt." *Reuters News*, December 1, 1995.

²⁸⁴ "Ministry says it acted at PSIS in shareholders' interest," *BBC Monitoring Service: Central Europe & Balkans*, April 27, 1995.

²⁸⁵ "PSIS does not accept being stripped of license," *CTK Business News*, July 9, 1996.

Like in the case of PSIPS, furthermore, the ministry appointed Harvard Investment Company as the new administrator of PSIS.²⁸⁶

The Harvard funds had been established in the early 1990s during the first round of voucher privatization in Czechoslovakia. With hundreds of thousands of vouchers being distributed to citizens, Viktor Kožený, who would later become known as the “Pirate of Prague,” sensed a lucrative opportunity. Together with Široký and the others, he established Harvard to buy up vouchers in exchange for shares in the fund. At its peak in 1994, Harvard was the largest non-bank investment fund in the Czech Republic, with a Kč60 billion portfolio consisting of stakes in 50 of the largest Czech companies. Far from receiving the 1000 percent return they were originally promised, investors in the Harvard funds eventually lost everything, for Kožený, Široký, and their partners simply stripped the assets. A 2006 indictment against Kožený by a Czech prosecutor details the scheme, which mostly involved selling for next-to-nothing the various shareholdings held by Harvard to Cypriot companies he and his associates controlled. Other methods were used as well. For instance, the indictment describes how Kožený, acting on Harvard’s behalf, bought shares in a Czech firm from a Cypriot company called Zenko Trading. The next week, Zenko sold the shares back to Harvard for much less than it had purchased them, benefiting Zenko at the expense of Harvard’s investors. “Kožený signed for Harvard, and his colleague, Juraj Široký, signed for Zenko,” the Czech prosecutor alleged. In all, there were six such transactions carried out by means of this “buy high, sell low” scheme, costing Harvard Kč250 million (\$10 million). In addition to the Czech indictment, Kožený also became the target of US authorities who sought him on fraud charges.²⁸⁷

Thus far, Kožený has managed to escape justice by fleeing to the Bahamas, where he now resides as the fugitive subject of an international arrest warrant. As for Široký, he was never charged. Nevertheless, at least one of my sources believes “he belongs in prison, because he did the same thing as Mr. Kožený. They were partners 10 years ago. And while Mr. Kožený is awaiting the American prosecutor, Mr. Široký is free, rich, and a very important person in Slovak political life.”²⁸⁸ Indeed, Kožený continues to enjoy success in business along with widespread political influence in Slovakia. Illustrating the role of feedback effects, he has reportedly been able to parlay the wealth he obtained from soft budget constraints and raiding into further opportunities to siphon state assets. He allegedly used his political influence great effect under the government of Prime Minister Róbert Fico, whose Smer party has ruled in a coalition with the HZDS for much of the past eight years. Under Fico, Široký’s companies have benefited from lucrative state contracts for various services including the building of highways and the renovation of Bratislava Castle. He reportedly helped engineer the appointment of Ľubomír Jahnátek, an old classmate and a former director of one of Široký’s companies, as Economy Minister. Following his appointment, Jahnátek nominated several close associates of Široký to the board of Transpetrol.²⁸⁹ He also has close ties to Transport Minister Ľubomír Vážny. According to one report, “Smer-nominated Transport Minister

²⁸⁶ Javurek, “FOCUS...”

²⁸⁷ “The spy who prospered.”

²⁸⁸ Interview with Respondent #55

²⁸⁹ “Mikloš: Jahnátek Influenced by Smer's Financial Backer Juraj Široký,” *Tlacova Agentúra Slovenskej Republiky*, December 6, 2006.

Lubomír Vážny 50th birthday party on Wednesday was attended by almost all those who the premier claims have nothing to do with his party - Miroslav Výboh, Juraj Široký, Rudolf Žiak, Milan Fil'o."²⁹⁰

As an aside, a good part of the rationale behind the attack on PSIS was its role in financing SME, the leading pro-opposition newspaper. It was on similar grounds that the Finance Ministry shut down the highly successful Bratislava Options Exchange²⁹¹ in 1995 (although this raid had no connection to Harvard); René Vochyan, its director and co-founder, was a vocal opposition supporter. Once Mečiar and the HZDS returned to power in late 1994, they quickly moved to neutralize the exchange. Magula's Finance Ministry revoked its license, again on highly dubious grounds, while the state companies that formed a major part of the exchange's ownership removed Vochyan from his post.²⁹²

One of the most colorful plutocrats on our list is Ján Slota, the radically xenophobic leader of the Slovak Nationalist Party (SNS). The SNS has been a frequent coalition partner in governments led by other scoundrels like the HZDS and Róbert Fico's Smer-SD. When he is not railing against the imagined enemies of the Slovak people, Slota is active in business (or what passes for it). This is despite the fact that he publicly disavows any alleged business activities and claims to live only on his official salary. Some of his private statements appear to contradict this claim, however. "Slota has been heard to say that he has so much money he doesn't know what to do with it," says one of my respondents.²⁹³

His reported wealth allegedly derives from two sources. The first is the "protection" of businesses in his home town of Žilina, where he was mayor for ten years. "Why doesn't Žilina have any mafia?" my source asks. "Well, because Slota *is* the mafia."²⁹⁴ According to rumors, no project could proceed there without his say-so. "Even if you wanted to open a food and vegetable stand," another source adds, "you had to get his approval."²⁹⁵

Whenever Slota is asked how his meager official salary affords him the luxury Porches and Bentleys he drives or the private jet he flies around in, he replies that they all belong to other people - "friends," he asserts, who are simply kind enough to let him "borrow" them whenever he likes.²⁹⁶ In this way, he bears a striking resemblance to the monks of the medieval Franciscan order. Initially famous for their stringent adherence to a vow of poverty, they became increasingly corrupt after the death of their founder, St. Francis. Chafing under a monastic rule that barred them from accepting donations from wealthy nobles, they obtained official permission from the pope to "use" the property of others so long as it did not officially belong to them. Few medieval Europeans were taken in by this fiction, nor is the Czech Newspaper *Týden*, which now lists Slota as one of the richest Slovaks.

²⁹⁰ "Sponsors," *TASR*, 19 July 2007.

²⁹¹ NPR #17

²⁹² Neil King Jr., "Meciar Mounts Hostile Bid for Slovakia." *The Wall Street Journal*, September 20; "Bratislava Options Exchange owes clients SK5bn," *CTK Business News*, 6 December 1995; "Revocation of BOB's license will not pass unnoticed – director," *CTK Business News*, November 15, 1995

²⁹³ Interview with source

²⁹⁴ Ibid.

²⁹⁵ Interview with Respondent #37

²⁹⁶ Interviews with Respondent #37, Respondent #48

That said, he is not known to be a criminal corporate raider. “Slota was all about extortion, not taking over the actual companies,” reports one source. “If you wanted anything to get done in Žilina, you had to pay Slota. If you did business there you had to give him a taste.” This particular source knows a businessman who put several million crowns in a bag to give to Slota. Upon entering his office, the man found him completely drunk behind his desk.²⁹⁷

The second alleged source of Slota’s wealth derives from lucrative soft budget constraints courtesy of the various governments in which his political party has been a member. Under Mečiar, the Defense Ministry arranged to pay its employees through PKB, a bank where Slota was board chairman and an alleged owner (despite being the mayor of Žilina, where PKB was based).²⁹⁸ Under the current government, a scandal erupted over the awarding of an overpriced state contract to companies closely connected to him. The so-called “bulletin-board tender” was so named because the only place where the tender notice was published was on a bulletin board located inside the Construction Ministry – where, needless to say, few would actually see it. The tender, worth €119 million, was awarded to the sole bidder, a consortium of two companies thought to be linked to Slota. In response to the scandal, Fico sought to distance himself from his coalition partner by firing several SNS-appointees allegedly implicated in the siphoning of state assets. Among them were the Environment Minister (for selling carbon credits at below-market rates) and the head of the foreign investment agency.²⁹⁹ Even Vladimír Mečiar had pointed words for Slota; “If, within a party, money is divided among the closest people and the party leadership, then this is cronyism. This cannot be called anything else” (not that there is anything wrong with that, he might have added).³⁰⁰

Vladimír Poór is another classic case of a political thug who stumbled into fabulous wealth on the basis of political connections alone. He featured in one of the biggest corruption scandals of the Mečiar era, a remarkable accomplishment given the multitude of shenanigans that went on at the time. In 1996, Poór’s company, Druhá obchodná, purchased a controlling stake in Nafta Gbely, the huge state gas monopoly.³⁰¹ Lacking any cash of his own to participate in the privatization, his only asset was his pledge to support the HZDS if he won the contract.³⁰² Poór also got his representative, Ján Gabriel, appointed as head of VÚB, the largest state bank. VÚB went on to finance many insider privatizations under Mečiar.³⁰³ Like Lexa, Poór fled abroad after the HZDS lost power in 1998, but soon returned when an international arrest warrant was issued for him. Nevertheless, charges of asset stripping at Nafta Gbely were ultimately dropped in January 2006.³⁰⁴ During negotiations with the Dzurinda government aimed at returning

²⁹⁷ Interview with source

²⁹⁸ Mikloš.

²⁹⁹ Luba Lesná, “Ministry tender linked to SNS allies,” *Slovak Spectator*, 8 December 2008; Ján Cienski, “Politics: Glimpse into a murky world,” *Financial Times*, 28 July 2009; Beata Balogová, “More investors express concern,” *Slovak Spectator*, 19 April 2010.

³⁰⁰ Lesná, “Ministry tender...”

³⁰¹ “Poór Testified, Says His Lawyer,” *Tlacova Agentúra Slovenskej Republiky*, September 8, 2000.

³⁰² Interview with Respondent #38

³⁰³ Ibid.

³⁰⁴ “Nafta Gbely Saga: Poór Not to Stand Trial,” *Tlacova Agentúra Slovenskej Republiky*, January 5, 2006.

Nafta to the state, Ľudovít Kaník, the head of the National Property Fund, claimed that the “Ukrainian mafia” tried to intimidate him into making a favorable deal with Poór.³⁰⁵

Poór eventually played a key role in setting up Smer, the current ruling party. His alleged intent was to secure the post of Transport Minister for his representative, Ľubomír Vážny, who would then appoint trusted associates to lucrative positions at state-owned companies.³⁰⁶ One of Poór’s business partners, Miroslav Lužák, in due course became Deputy Chairman of the state rail-freight company (but later resigned under pressure from the media and opposition parties).³⁰⁷ Although certainly implicated in major cases of siphoning, Poór is not known as a criminal corporate raider.

Jozef Brhel is another political thug. A former classmate of Ivan Lexa and Juraj Široký, his business career has been closely linked to politics from the start. It got off the ground in large part thanks to his role as Deputy Minister of the Economy in the third Mečiar government (1994-98), during which time he allegedly became wealthy from his political connections. He is active in a range of politicized industries including real estate, finance, and, especially, energy. Since leaving power his companies have received lucrative state contracts. Cogen West, which produces heat and electricity, benefits from state support to the extent that the prices the state pays for its output reach 125 percent above market. The contract was signed during the second Dzurinda government (2002-2006). Brhel's fortunes greatly expanded under the Smer-led governments of Róbert Fico. Brhel, along with Poór, Široký, and Výboh, are thought by some to be the main recipients of state contracts under Fico. This may in part be attributed to the fact that his former employee, Róbert Kaliňák, is the Interior Minister. During the 1990s, Kaliňák reportedly helped Brhel and Lexa launder a state asset they had privatized. In his new role as Interior Minister, Kaliňák has been well-known for arranging the sale of state contracts to his cronies. During Fico's first government (2006-10), Brhel was allegedly one of the people behind Inter Blue, a company that bought quotas to emit carbon dioxide at half their true value. Later, his name was apparently "omitted" from a list of Inter Blue beneficiaries that Swiss authorities provided to the Slovak prosecutor's office.³⁰⁸

Among the names of Slovakia’s richest political thugs, Ivan Kmotrík also deserves mention. A “former money-changer who enjoys a reputation both for friendships with underworld figures and for having a big heart.”³⁰⁹ Kmotrík was allegedly involved in the heating oil scam in the 1990s through his links with organized crime boss Peter Čongrády. However, he really made it big after privatizing Grafobal under Mečiar for less than 10 percent of its value.³¹⁰ It was on the back of this

³⁰⁵ “Slovak privatization head says Ukrainian mafia threatens him,” *RFE/RL Newswire*, 28 July 1999.

³⁰⁶ “From the Slovak Press,” *CTK Daily News*, November 23, 2006; “Slovak Press Survey,” *CTK Daily News*, July 4, 2006.

³⁰⁷ “Mikloš: Jahnátek Influenced by Smer's Financial Backer Juraj Široký.”

³⁰⁸ Matúš Burčík, “Široký, Poór, Brhel či Flašík. Obchodníci z HZDS sa ujali pri Ficovi,” *SME*, 25 September 2013; Beata Balogová, “Interblue mystery begins to unravel,” *Slovak Spectator*, 6 February 2014; Michaela Terenzani-Stanková, “Slovak media laps up new WikiLeaks”; Lukáš Fila, “Jachty,” *Slovak Spectator*, 12 April 2012; Zuzana Petková, “Brhel odtajnil tvár aj biznis,” *Trend*, 25 November 2013; Eva Mihočková, “Firma s väzbou na Brhela tají zmluvu so štátnou akciovkou, ktorú má na 15 rokov,” *Plus 7 dní*, 14 June 2013; Tom Nicholson, “Did she fall or was she pushed,” *Slovak Spectator*, 27 March 2006 (<http://spectator.sme.sk/articles/view/22878/2/>).

³⁰⁹ Nicholson, “Who are the richest Slovaks?”

³¹⁰ Interview with Respondent #55

privatization that he formed his holding company, Grafobal Group, which is worth billions of crowns and has assets in sports, printing, publishing, media distribution, and manufacturing. A close associate of Bratislava criminal boss Jozef Svoboda (murdered in 2004), he also partnered in various businesses with Vladimír Poór and members of the Lexa family.³¹¹ However, he has not been directly implicated in criminal corporate raiding.

Three other plutocratic political thugs on our list are Milan Fil'o, Juraj Kamarás, and Ladislav Krajňák. They vaulted into the ranks of Slovakia's richest after Kamarás assumed a post at the National Property Fund in 1994, which allowed them to privatize a paper mill, SCP Ružomberok, to themselves. They later inked an agreement with a foreign company to sell half of SCP in a deal that brought them billions of crowns.³¹²

Finally, there are two individuals whom I cannot definitively classify as political thugs; they may in fact be crony capitalists. The first is Ivan Chrenko. Chrenko rose to immense wealth in the politicized sector of real estate development, founding HB Reavis Group in the early 1990s. The company has participated in many major real estate projects, particularly in Bratislava. Among these were the Bratislava Business Center, the Apollo Business Center, and the Forum Business Center. In many cases, HB Reavis purchased the land from the state. I could not find information as to whether and by how much these purchases were subsidized and if, in turn, the real estate projects actually added economic value on top of any subsidies received. Because of this, I was unable to determine if Chrenko is a crony capitalist or political thug. However, he is clearly not an entrepreneur.³¹³

Another uncertain case is Ľubomír Blaško. Blaško made his early fortune in the coal trade and then moved into other activities in the energy sector. Over the years his businesses have clearly benefited from soft budget constraints granted by virtue of his political connections. During the second Dzurinda government (2002-2006), his company, Minerfin, received a large contract to supply coal to state-owned electricity producer Slovenské elektrárne. The Economy Ministry, which awarded the contract, was headed at the time by Pavol Rusko, leader of the New Citizens Alliance party (ANO), a member of the ruling coalition. When details surfaced that Blaško had previously extended a personal loan of SKK 104 million to Rusko, Rusko was forced to resign. But that did not stop Blaško's firms from continuing to profit from government contracts. Blaško died prematurely of a heart attack in 2004 and was succeeded by his wife, Mária. Even before his death, he had begun making preparations in the event that the Dzurinda government would lose power. In exchange for substantial donations to Smer, then an opposition party, he was promised the right to fill a number of key posts in a future government in addition to key state companies. A firm linked to his brother, Jozef, bought a property from Slovak Telecom in October 2007 for SKK 100 million (EUR 3.3 million). A few months later Jozef turned around and sold the same building to the state-owned Slovak Nuclear and Decommissioning Company (JAVYS) for SKK 243 million.

³¹¹ Tom Nicholson, "The media business doesn't interest me," *Slovak Spectator*, 22 January 2007.

³¹² Nicholson, "Who are the richest Slovaks?"; "New Structure of Pulp and Mill Company SCP Bodies Approved," *SITA*, 10 November 2000.

³¹³ "Poslednej štvorke slovenských milionárov vládne Ivan Chrenko," *Plus 7 dní*, 3 June 2013; Ľuboš Mistrík, "Veľké zmeny vo vedení HB Reavis, ide sa do Londýna," *Trend*, 4 October 2013; Ján Blažej, Ivan Haluza, Pavel Kováč, Eduard Žitňanský & Radovan Žuffa, "Zoznam slovenských miliardárov," *PROFIT/Trend*, 30 September 2008.

While Blaško and his successors are clearly not entrepreneurs, I could not find enough information to determine if they should be classified as crony capitalists or political thugs.³¹⁴

Crony Capitalists and Entrepreneurs

While the vast majority of Slovakia's plutocratic elite are political thugs, many of the remainder are crony capitalists. One of these is Andrej Babiš. Currently the richest Slovak, Týden calls him "a real predator with a dark past." A clever former ŠtB agent, the foundation of his fortune was the stripping of assets from state-owned Agrofert, a major chemicals manufacturer and importer. He allegedly did so by setting up companies in Ukraine that vastly overcharged Agrofert for inputs. "It had a profit of \$2 billion one year and the next year it was bankrupt," one source says. "It was very, very quick."³¹⁵ The newspaper that printed that story was successfully sued by Babiš for libel, although what, if anything, that means in a country whose courts are as corrupt as Slovakia's is anyone's guess. His base of operations is in the Czech Republic but he has large holdings in Slovakia as well. In fact, even though he got his start in business due to soft budget constraints, he is a rare case of someone who actually made something of the assets he allegedly stole. Agrofert has acquired more than 100 firms and "is a major player in the agriculture, food and chemicals sectors, where it is the largest producer of nitrogen fertilizers in Europe."³¹⁶

Another crony capitalist is Štefan Rosina, Jr. He is generally hailed for turning Matador Púchov, the state company his family formerly managed, into a European powerhouse in the manufacture of tires. However, his father, Štefan, Sr. had close ties to the notorious HZDS Economy Minister Ján Ducký around the time he privatized the plant in the mid-1990s. This is enough to raise questions about the possible role of political connections the family's success.³¹⁷

In addition to crony capitalists, there are four entrepreneurs on the list as well. Three of these belong to the same business group. Rudolf Hrubý, Peter Paško, and Miroslav Trnka founded Eset in 1992. By that time, they had already demonstrated their ability to make innovative products; in 1987, Paško and Trnka discovered one of the world's first computer viruses and developed the technology for detecting it. Eset now has branches all over the world and is one of Europe's fastest growing companies. It has won numerous awards both for its software products and its approach to corporate social responsibility.³¹⁸

The other entrepreneur is Peter Vajda. He founded the First Slovak Investment Group (PSIS), which became the largest privatization fund in Slovakia in the early 1990s. He also established the newspaper SME, which led the charge against the Mečiar government in the Slovak media. The fact that PSIS provided financial backing to SME

³¹⁴ Michaela Kušnírová, "Ľudia, ktorých spája meno Eubomír Blaško," *HN Online*, 16 December 2013; Marek Vagovič, "Blaškov človek mal za Fica biznis," *SME*, 23 August 2008; Monika Ščevovichová, "Dedička," *Plus 7 dní*, 11 April 2008.

³¹⁵ Interview with source

³¹⁶ Nicholson, "Who are the richest Slovaks?"

³¹⁷ Peter S. Green, "A Slovak Approach to Privatization," *The New York Times*, 30 May 1996.

³¹⁸ Radka Minarechová, "Slovak companies succeeding abroad," *Slovak Spectator*, 18 November 2013.

likely constitutes one reason why the Mečiar government raided fund in 1995. I could not find any evidence that political connections played a role in Vajda's success.³¹⁹

Finally, there are two plutocrats who may either be entrepreneurs or crony capitalists; I could not obtain enough information to definitively classify them except to confirm that they are not political thugs. The first is Vladimír Soták. Along with six other managers at state-owned Podbrezová Ironworks, Soták formed a consortium to buy the steelmaker during the first wave of voucher privatization in the early 1990s. They acquired it cheaply, in part due to heavy losses the company suffered at the time. But they subsequently turned it around and bought out most of the remaining shareholders. Podbrezová has turned a profit most years since 1995. Soták is known for his close ties to politicians, particularly Prime Minister Róbert Fico, although I could not determine how important political contacts were to his early business success. Hence, while not a political thug, it remains unclear whether he is an entrepreneur or crony capitalist.³²⁰

The second uncertain case is Martin Blaškovič. His company, HTC Holding, participated in voucher privatizations in the early 1990s ended up with a portfolio of manufacturing firms as a result. He is clearly not a political thug; he was instrumental in restructuring Zetor, the bankrupt Czech tractor-maker, after privatizing it. But I could not find enough information to indicate whether he is an entrepreneur or crony capitalist. Certainly, his business association with Zoroslav Kollár, a political thug of the first order, is enough to raise some doubt.³²¹

The Failure of Property Rights Institutions in Slovakia

That criminal corporate raiding has been such a frequent occurrence – in practically all sectors of the economy and among both the plutocratic and non-plutocratic elites – implies by its very fact that that Slovakia's property rights institutions are not doing their job. This section will provide further evidence to back up this claim and explain why these institutions became so weak in the first place.

If frequent raiding was the result of the abundance of political thugs, a surplus of crony capitalists as well as political thugs was responsible for Slovakia's weak property rights institutions. The reason is that both crony capitalists and political thugs depend on corrupt access to the state. As long as deep networks of such actors remain entrenched, they will constantly seek to bribe state officials, many of whom will have a hard time turning down the lucrative opportunities. These conditions are not amenable to the development of legal rules that are evenly and impersonally enforced upon society.

The failure of Slovakia's revolutionaries to implement hard budget constraints during the early 1990s are what allowed these actors to take root. Political thugs and crony capitalists were subsequently able to use their access to soft budget constraints to

³¹⁹ Mikloš.; Gabriel Beer & Martin Vavřínek, "Peter Vajda: S morálkou v biznise je to už lepšie," *Trend*, 7 April 2004; "SME: Mečiar's scourge, and a digital pioneer," *Slovak Spectator*, 28 January 2013; Tomáš Gális, "Peter Vajda: Plánovali SME na Silvestra," *SME*, 14 January 2013.

³²⁰ Ján Blažej, Ivan Haluza, Pavel Kováč, Eduard Žitňanský & Radovan Žuffa, "Slovenskí miliardári: Akí vlastne sú," *PROFIT/Trend*, 28 October 2008; "Vladimír Soták: Súčasná vláda je lepšia, než bola tá Dzurindova," *HN Online*, 30 July 2007.

³²¹ "Slováci Zoroslav Kollár a Martin Blaškovič chtějí po Česku už jen 808 612 489,16 korun," *moteljek.com*, 14 October 2009, accessed 9 August 2014 (<http://www.moteljek.com/slovaci-zoroslav-kollar-a-martin-blaskovic-chteji-po-cesku-uz-jen-808-612-48916-korun>).

place their patrons into power during most of the mid-1990s. Once in control, Mečiar and the HZDS actively worked to hobble the development of incipient property rights institutions. They adopted increasingly burdensome tax rules, boosting the comparative advantage those business actors with the necessary connections to skirt them. Onerous taxes also enabled the HZDS to use the state to harass any rival actors whenever necessary; according to Mikloš, from 1993 and 1996 the tax burden on private companies rose from 37 percent to 45 percent, in comparison to an OECD average of 39 percent. Meanwhile, the government kept bankruptcy laws weak throughout the 1990s, privileging debtors to such an extent that few creditors even tried to recover their property in bankruptcy court.³²²

The HZDS also made sure that key state bodies remained understaffed so as to compromise their capacity to enforce property rights. For instance, by the time Dzurinda came to power in late 1998, the National Bank of Slovakia had only 13 on-site examiners who could properly supervise banks. As a result, a grand total of one on-site audit was carried out in 1999 with another four in 2000. No wonder politically influential figures with ties to banks could strip them of assets so easily. In addition, securities markets remained tiny well into the first decade of the twenty-first century; Slovakia had the lowest stock market capitalization in the OECD while its bond market was small, feeble, and traded mostly government issues.³²³ After interviewing dozens of state officials in Slovakia, Poland, and the Czech Republic, Conor O'Dwyer concluded that "it is hard to discern the glimmerings of bureaucratization in any of these countries;" all tend to approximate the former Soviet republics in this regard. He also describes "a state administration that ebbs and flows on the tides of electoral politics" with frequent purges following elections and little cultivation of professional bureaucratic careers.³²⁴

Even Dzurinda and the SDKÚ, which came to power with high expectations to reduce corruption, quickly gave in to the peculiar logics of Slovak politics; if they refused to accommodate the by-now well-entrenched constituency of political thugs and crony capitalists, the ample financial resources these groups controlled would simply flow toward the government's opponents. Consequently, Dzurinda chose to accommodate them, and this meant keeping property rights institutions sufficiently weak and corruptible. This is a choice frequently made by initially reformist governments in early-capitalist countries like Slovakia. Lacking the political connections necessary to thrive in such an environment, entrepreneurs often find themselves on the receiving end of the agents of economic predation as a result.

The Dzurinda government finally gave the country a civil service law in 2001. But, as O'Dwyer shows, the law set a very low bar for professional qualifications and was evidently designed to help the government maintain job security for its own appointees.³²⁵ Dzurinda did implement some real reforms aimed at least in part to enhance property rights protections and weaken those opposed to this goal. Financial reforms improved the procedures for dealing with insolvent banks.³²⁶ The introduction of

³²² Mikloš.

³²³ "Slovakia risk: Financial risk."

³²⁴ O'Dwyer, 87, 95-96.

³²⁵ Conor O'Dwyer, *Runaway State-Building: How Parties Shape States in Post-Communist Poland, the Czech Republic, and Slovakia* (Berkeley: University of California, Berkeley, 2003), (Unpublished PhD Dissertation), 134.

³²⁶ "Slovakia risk: Financial risk."

a flat tax reduced opportunities for corruption by tax collectors and evasion by taxpayers. The process for obtaining business licenses was streamlined too.³²⁷

An online business register was additionally established – in English as well as Slovak – to increase transparency in the ownership and control of companies; indeed, to this day one can easily identify the shareholders and directors of all corporations through the website. The criminal code was amended to allow for the use of “agent-provocateurs” to bait public officials into taking bribes, thereby aiding corruption fighters in law-enforcement.³²⁸ Rules were also adopted mandating the random assignment of court cases to judges in order to prevent its abuse by corrupt court chairmen. The government changed bankruptcy regulations twice, first in 2000 to improve the status of creditors and again in 2006 to counter artificial bankruptcies.³²⁹ Meanwhile, the cabinet adopted a National Anti-Corruption Program in June 2000. Most notable, however, was the creation of the Special Prosecutor and Special Courts. These bodies were charged with investigating and prosecuting corruption cases without having to rely on the notoriously corrupt judicial system.

Unfortunately, if some of the above measures led to real progress, others were hampered by government foot-dragging. Transparency International criticized the slow implementation of the anti-corruption program, noting that the government unnecessarily extended the preparation phase and parliament proved slow in adopting the necessary legislation.³³⁰ Despite all his rhetoric about punishing Mečiar-era abuses, Ladislav Pittner, the SDKÚ Interior Minister, failed to bring any HZDS cronies to court.³³¹ Meanwhile, the Dzurinda government’s signature anti-corruption achievement, the creation of the Special Courts and Special Prosecutor, came only after the coalition was brow-beaten into establishing these bodies; it took a scathing EU Commission report in 2002 that lambasted the government’s anti-corruption record over the previous four years to actually spur action on the issue.³³² (While the European Union seemingly played a positive role in this particular instance, it has not managed to reduce raiding or improve the protection of property rights; the Special Courts achieved some notable victories but these represented a few drops in the pond.)

Well into Dzurinda’s second term, a Transparency International poll found that 65 percent of firms that acknowledged making campaign contributions did so mainly to win government contracts. Forty-seven percent said they also did so to place “their own” people in the state administration and 39 percent sought favorable regulatory decisions.³³³ Clearly, anti-corruption was not at the top of the ruling coalition’s agenda. This is little wonder given the sort of economic criminals the ruling coalition had to rely on for

³²⁷ Interview with Respondent #48

³²⁸ “Agent provocateurs to be used in Slovakia for abetting corruption,” *CTK Daily News*, November 7, 2003.

³²⁹ “Ability of Slovak Companies to Repay Debts Improves, shows Survey,” *SITA*, April 16, 2007; “SME - New Bankruptcy Act to Clean Up the Business Environment,” *SITA*, June 21, 2000.

³³⁰ “Transparency International Critical of Anti-Corruption Program,” *Slovenská Tlacova Agentúra*, December 19, 2000.

³³¹ Barbora Maroszova, “Slovak Interior Minister’s Resignation Sparks Coalition Crisis.” *Transitions Online*, May 21, 2001.

³³² “Slovak Transparency International urges new measures to fight corruption,” *BBC Monitoring European*, October 13, 2002.

³³³ “Slovakia politics: Secret service scandals.”

campaign financing and who constantly enticed public officials into illicit collusion with them.

The ouster of Dzurinda by Fico in 2006 reversed whatever progress had been made under the preceding administration. Fico and his coalition allies, which would include the HZDS and Ján Slota's SNS, rode to power on the back of staunch support by many of Slovakia's most notorious political thugs. His government passed a law in 2009 allowing state posts to be filled by "internal selection procedures" rather than public competitions. Naturally, the changes have resulted in nepotism in state appointments.³³⁴ But it would be Fico's Justice Minister, Štefan Harabin, would lead the charge in restoring the capacity of corrupt business actors to carry on their illicit dealings with impunity. To start with, he abolished the system of randomly assigning court cases to judges.³³⁵ In addition, he eventually won a hard-fought battle to eliminate the Special Courts and Special Prosecutor.

There were some reforms that Fico was not able to reverse, such as the online business register. But once corrupt business actors become entrenched, they can usually find ways to subvert any institutions designed to boost transparency. Indeed, Slovakia's political thugs and crony capitalists have easily outmaneuvered the constraints posed by the business register by relying on white horses to represent their interests in corporations (good luck finding entries for "Alojz Lorenc" in the register's search engine).

Meanwhile, the judicial system remains notoriously corrupt to this day. Lamenting the inability of the courts to resolve civil disputes, Tom Nicholson notes that "One of the greatest facilitators of corruption is the fact that people can be bought at any level of the judicial system... People know that if you let things go to the courts you're very likely to lose if the other guy has the judge and, even if you do win, it is going to take you decades. So these things tend to be settled either through agreement or by force, by people taking the law into their own hands."³³⁶ Until the Special Courts were established, no judge had ever been convicted of corruption. As Dušan Kováčik, the Special Prosecutor, complained, "I know prosecutors who don't earn nearly one-third of what I earn but who build expensive homes, buy expensive cars, and travel abroad on expensive vacations."³³⁷ Another source speaks of a kind of "brotherhood" among judges whereby no judge will rule against another.³³⁸

Judges are well-known for stalling cases beyond the relevant statutory deadlines in order to let organized crime-linked defendants off the hook. One judge was dismissed after facing accusations of delaying the trial of defendants implicated in the execution of ten members of the Papay gang. This was the biggest mass murder in the country's post-communist history, but the judge let lapse the five-year limit on keeping defendants in custody.³³⁹ The alleged killers of another criminal boss, Miroslav Stojka, were freed on a

³³⁴ Michaela Terenzani – Stanková, "Agriculture minister accused of nepotism, prime minister stands by him," *Slovak Spectator*, 7 October 2013 (http://spectator.sme.sk/articles/view/51569/2/agriculture_minister_accused_of_nepotism_prime_minister_stands_by_him.html).

³³⁵ Interview with Respondent #41

³³⁶ Interview with Tom Nicholson

³³⁷ Interview with Dušan Kováčik

³³⁸ Interview with Respondent #40

³³⁹ "One of suspects in largest mass murder case leaves prison," CTK Daily News, September 24, 2004.

technicality after the Košice regional court judge missed a crucial deadline.³⁴⁰ Jaroslav Spišiak, the former head of the organized crime police unit, was stymied in his efforts to go after members of the Takáč gang. This was after a court ruled that their alleged involvement in protection rackets did not violate the anti-racketeering law but merely the Law on Security Companies, which only carries a fine, not a jail sentence. Recognizing the fruitlessness of such efforts, law-enforcement agencies have tended to avoid prosecuting alleged racketeers ever since.³⁴¹

The situation in the courts has if anything worsened in the last few years, thanks in good measure to Štefan Harabin. After serving as Justice Minister, Harabin was later appointed President of the Supreme Court. Aside from engineering the destruction of the Special Courts, the only institution to have had any success prosecuting corruption in post-communist Slovakia, he has faced widespread complaints for abuse of power. In 2009, an open letter from 15 judges blasted Harabin's alleged intimidation and selective treatment of judges. They accused him of using disciplinary proceedings to get rid of uncooperative judges; "it seems that the common denominator [in the initiation of disciplinary actions] is criticism of Supreme Court and Judicial Council head Štefan Harabin." One judge, Peter Paluda, was suspended after filing a criminal complaint against Harabin for allegedly exceeding his prerogatives. Helena Kožíková, a member of the Judicial Council, offered what was in her eyes a perfectly reasonable defense of Paluda's suspension; "whether anybody likes it or not, it is at odds with judges' ethics to file criminal complaints against the chairman of the court or a colleague."³⁴² Another judge, Anna Benešová, accused Harabin of trying to pressure her for a favorable ruling in two cases that involved libel lawsuits Harabin had filed. Harabin had initiated the suits against the owners of newspapers that wrote critical stories about him. Having failed in his attempts to intimidate Benešová, he allegedly arranged to have her demoted on a highly questionable legal pretext.³⁴³

According to the open letter cited above, Harabin acted arbitrarily in his treatment of judges subject to disciplinary proceedings for similar offenses. While some were dismissed outright, another, Miriam Sninská, was allowed to continue in her position for years as corruption proceedings against her made their way through the system. She just happened to be the niece of an MP from the HZDS, the party which appointed Harabin as Justice Minister in the first place. Katarína Tóthová, a member of parliament's Constitutional Committee, lambasted the open letter, without any hint of irony, as "an absolute intervention into the impartiality of the judiciary." Zuzana Wienk of the anti-corruption NGO Aliancia Fair-Play harshly criticized Harabin and the Judicial Council: "In my opinion, we are now getting to a stage where the abuse of power in the justice department is immense and shocking. At the same time I view these disciplinary proceedings as a way of direct liquidation of the opponents of the Supreme Court President without signs of fairness, legality and neutrality."³⁴⁴

Clearly, Slovakia has a long way to go before its property rights institutions can be deemed effective and impartially enforced.

³⁴⁰ "Alleged Košice Mafia Boss Murdered," *TASR*, November 28, 1999.

³⁴¹ Interview with Tom Nicholson

³⁴² Beata Balogová, "Fifteen judges sound loud warning," *Slovak Spectator*, 21 September 2009)

³⁴³ "Judge says her independence was pressured," *Slovak Spectator*, 20 July 2009

³⁴⁴ Balogová, "Fifteen judges sound loud warning."

Conclusion

As in Ukraine, the role of actors would prove paramount in shaping the integrity of Slovakia's institutional framework. Institutions in the form of soft budget constraints would indeed prove responsible for enriching and empowering a class of economic criminals. But it was the actors who made up the early post-communist governments who essentially chose to deprioritize the hardening of budget constraints in the first place. It was the actors that inherited the ousted communist party organization who failed to turn it into the kind of viable social-democratic party that might have checked the worst excesses of privatization fraud. And it was the economic criminals that rose on the back of soft budget constraints who actively undermined the construction of effective property rights institutions.

The preceding discussion has shown in great detail the way soft bank loans, a massive tax-evasion scheme in heating oil, over-priced tenders, and corrupt sales of state enterprises at absurdly low prices channeled state resources into the hands of economic criminals. This process occurred in both the plutocratic and non-plutocratic spheres. With political thugs occupying such a prominent place among the business elite, it was virtually inevitable that criminal corporate raiding would become so frequent. In addition, along with crony capitalists, the political thugs who wield so much influence over political life have proved able to bend to their will even the most well-designed state institutions.

Because this has been such an easy feat for economic predators, the most immediate priority for any future reformist government is not to try and create better-designed rules and enforcement mechanisms. Instead, vigorous and rapid measures must be taken to weaken the political thugs and crony capitalists who hold such sway over the economic realm. The imposition of hard budget constraints, not simply the establishment of better rules, would provide the most bang for the buck in achieving this goal. Because the banking system is no longer afflicted to such an extent by politically-driven lending and non-performing loans, further improvements in the quality of banking rules and supervision would not yield much benefit. Instead, the soft budget constraints that are most relevant today are fraudulent and overpriced tenders for public services along with corrupt privatizations at below-market cost. Allowing real competition in such contests would go a long way toward shifting the balance against the networks of political thugs and crony capitalists. Even greater leverage would obtain from a legal and honest process of reprivatization to rectify the corrupt privatizations that placed state wealth into the wrong hands in the first place.

“We tried to understand the sources of the key fortunes in Poland. We noticed that the sources, the roots of these fortunes, started in this domain of international trade, which was under the strict control of the intelligence services. And from this stems the conclusion that, without some sort of compliance with the intelligence agencies, they could not pursue their business.”

—Andrzej Zybertowicz¹

“[T]wo transformations occurred in Poland. Overt, which consisted in the transformation of the structures of the Communist state and economy into [the] formal institutions of parliamentary democracy and [a] market economy and another transformation—covert—which consisted in [the] local modification and shaping (interpretation) of the new institutions and rules in order to make them serve the transformed Communist elites and co-opted segments of the elite originating from the former opposition.”

—Zdzisław Krasnodębski²

“It is as if the three of us here said we were going to manufacture F-16s.”

—Former investigative journalist Jack Łęski on the multi-million dollar state contract awarded to political thugs Zygmunt Nizioł and Włodzimierz Wapiński to build a plasma fractionating laboratory.³

Chapter Six

Real Conspiracies in Post-Communist Poland

A multitude of scholars and other specialists have hailed Poland as one of the post-communist leaders in limiting corruption and establishing property-rights and other market-supporting institutions.⁴ The victories of Solidarity in elections held between

¹ Interview with the author, 22 April 2008.

² Cited in Andrzej Zybertowicz, "Anti-Development Interest Groups (Preliminary Outline)," *Polish Sociological Review* 149, no. 1 (2005): 73.

³ Interview with the author, 8 April 2008.

⁴ Gould, 103-04; Vachudova; Frye, *Building States and Markets after Communism: The Perils of Polarized Democracy*; Schoenman, "Captains or Pirates? State-Business Relations in Post-Socialist Poland."; Grzymała-Busse, 81-87; Woodruff, "Property Rights in Context: Privatization's Legacy for Corporate Legality in Poland and Russia."; Shleifer and Vishny, chapter 11; Schwartz and Gans-Morse; Stiglitz, chapter 7; Easter; IBRD & The World Bank, 11.

1989 and 1991 ushered in an era of sustained democratic consolidation that persists to this day. In addition, under the stewardship of the legendary Leszek Balcerowicz, Poland's radical market reform program heralded 20 years of robust economic growth.

For many specialists, the success of Polish reform exceeded even that of other leading post-communist countries such as Czechoslovakia and its successor states; while they may have followed the neoliberal reform model, they ignored the need to establish sound institutions and the rule of law in economic relations. Along with Hungary, Poland is typically considered an exception to this pattern. Few would dispute that corruption remains a problem, but equally few would expect that investors and business owners are anywhere near as vulnerable to asset expropriations as they are in places further east, such as Ukraine or Russia.

This chapter will present a mountain of case-study evidence that casts serious doubt on these claims. To be sure, Poland's plutocratic elite has displayed a far lesser proclivity toward criminal corporate raiding than its counterparts in Slovakia and Ukraine. Whereas 47 percent of Slovak plutocrats and 35 to 45 percent of Ukrainian plutocrats can be classified as raiders, the corresponding figure for Poland is 13 to 15 percent (Tables 6.1 and 1.6). This is an important difference that merits explanation.

The reason why the plutocratic elite contains a smaller proportion of raiders is that it does not contain as large a share of political thugs. But even if there are comparatively fewer political thugs, the bulk of Poland's plutocratic elite – between 56 and 69 percent – still consists a combination of political thugs and crony capitalists – just as in Ukraine and Slovakia. These numbers are somewhat lower than the corresponding figures for Ukraine (83 to 98 percent) and Slovakia (77 to 88 percent). But, in contrast to Estonia, these two actor-types still constitute a decisive majority of the Polish plutocratic elite (Tables 6.1 and 3.5).

Furthermore, when one looks beyond the small stratum of ultra-wealthy billionaires, the situation appears largely identical to the one prevailing in Ukraine and Slovakia. Poland's non-plutocratic elite is infested with political thugs who have consistently used the state's organs of force to illegally bankrupt and seize scores of businesses. Of the nine economic sectors identified by the United Nations, this investigation has uncovered raids in seven (Table 6.2). This places Poland's non-plutocratic sphere on par with those of Ukraine (seven) and Slovakia (eight). By comparison, in Estonia I found non-plutocratic raids in only two sectors.

Taken together, the dozens of cases that follow depict a country that remains burdened by widespread and systematic property rights abuses of the worst imaginable kind.

The causal forces that produced this outcome are broadly similar to those observed in Ukraine and Slovakia. They likewise demonstrate the importance of analyzing how actors shape institutions rather than limiting our inquiries to the role of institutions in shaping actors. The failure of the first post-communist governments to harden budget constraints on economic actors allowed tides of state money to flow into the hands of incipient political thugs and crony capitalists. As a result, such actors have come to occupy a privileged position at the expense of entrepreneurs.

The fact that the plutocratic elite contains fewer political thugs than in Ukraine or Slovakia is due to the relatively honest character of the formal privatization process,

Table 6.1. Poland's Plutocratic Elite

Name	Alleged Type	Raiding?
Anna Podniewska	CC	
Bogusław Cupiał	CC	
Józef Wojciechowski	CC	
Marek Mikuśkiewicz	CC	
Mariusz Świtalski	CC	
Roman Karkosik	CC	
Zbigniew Jakubas	CC	X
Zbigniew Komorowski	CC	
Zbigniew Niemczycki	CC	
Michał Sołowow	CC	
Wiesław Likus	CC	
Krystyna Koelner	CC or E	
Marian Kwiecień	CC or E	
Bogdan Kaczmarek	E	
Dariusz Miłek	E	
Jacek / Tomasz Domogała*	E	
Jarosław Pawluk	E	
Krzysztof Jędrzejewski	E	
Krzysztof Klicki	E	
Tadeusz Chmiel	E	
Przemysław Sztuczowski	E	
Andrzej Czernecki	E	
Robert Kamiński	E	
Mariusz / Edgar Łukasiewicz*	E	
Leszek Czarnecki	E	
Heronim Ruta	PT	X
Grażyna Kulczyk	PT	?
Grzegorz Jankiewicz	PT	
Jan Kulczyk	PT	
Jerzy Starak	PT	
Mariusz Walter	PT	X
Ryszard Krauze	PT	
Sławomir Smołokowski	PT	
Jan Wejchert	PT	X
Zygmunt Solorz-Żak	PT	X
Aleksander / Tomasz Gudzowaty*	PT	
Henryk Stokłosa	CC or PT	
Jerzy Wiśniewski	CC or PT	
Maciej Adamkiewicz	CC or PT	

*Inheritor

Raiders	% of Pluto Elite
Raiders	12.8%
Possible Raiders	15.4%
Actor-Types	
E	30.8%
E or CC	5.1%
CC	28.2%
CC or PT	7.7%
PT	28.2%
Entrepreneurs	30.8% to 35.9%
Crony Capitalists	28.2% to 41.0%
Political Thugs	28.2% to 35.9%
CC & PT Combined	56.4% to 69.2%

Key

CC = Crony Capitalist

E = Entrepreneur

PT = Political Thug

particularly the sales of the largest state enterprises. That Polish privatization involved less outright fraud was due in turn to the much stronger character of party competition.

However, other forms of soft budget constraints proved abundant, from unrestrained bank lending in the 1990s to overpriced public contracts and one-sided transactions with state enterprises. These sources provided early fortunes for scores of political thugs among the non-plutocratic elite. They similarly account for rise of those plutocrats who can be considered political thugs.

As we will see, there was a lack of sufficient action by the first post-communist governments to harden budget constraints. That said, the range of choices available to Polish leaders was arguably more restricted than in Slovakia. This was due to the nature of the transition. In Czechoslovakia, the anti-communist opposition completely swept the nomenklatura from office. This gave its early reformist governments considerable leeway to swiftly and effectively subject economic actors to hard budget constraints. Unfortunately, it was an opportunity they failed to seize; state assets continued to flow into the economic sphere, leaving Slovakia's new economy beholden to political thugs and crony capitalists. In Poland, the transition did not proceed through the wholesale replacement of the communist regime; instead, it was the end-product of negotiations between the ruling party and the opposition Solidarity movement. Solidarity was not strong enough to force the communists to cede power unconditionally, and the conditions to which it agreed – namely, the legitimization of assets already stolen by the nomenklatura and the provision of continued opportunities to steal – constrained the capacity of post-communist governments to cut off the supply of soft budget constraints. At the same time, the range of choices available to them was arguably wider than in Ukraine, where the first post-communist government, dominated as it was by the former nomenklatura, had little to no chance of severing business actors from politically-engineered soft budget constraints. But the limits Polish policymakers confronted were nevertheless real and did restrain their scope for action.

The end result was weak property rights institutions. These institutions remain easily manipulated by political thugs and their co-conspirators among current and former members of the state intelligence agencies, judges, tax officials, regulators, prosecutors, and police. In case after case, we will see real-world conspiracies at work in Poland whereby networks of such criminals collude to destroy businesses, jail the owners on trumped-up charges, and split the remaining assets among themselves. Any future attempts to strengthen such institutions must confront the power of these networks. Unless new governments arise that undermine corrupt business actors by cutting them off from soft budget constraints, institution-building efforts are likely to falter.

Elite Ascendance and Capital Accumulation

Let us begin by examining the key feature that distinguishes Poland from Ukraine and Slovakia: a formal privatization process that was by and large free of blatant giveaways of state companies. The reason why Poland avoided the kind of overt privatization fraud the other two countries witnessed was the strength of competition among its political parties.

Unlike Slovakia, Poland would not only witness the ascendance of revolutionaries during the transition but would also come to feature far stronger party competition. The

Table 6.2. Alleged Non-Plutocratic Raids

<u>Raid #</u>	<u>Target</u>	<u>Sector</u>	<u>Alleged Perpetrator</u>	<u>Pol. Thug?</u>
1	BIG Bank-Gdański	6	BIG Bank-Gdański	Yes
2	Lublin Brewery	2	Stanisław Pacuk/Kredyt Bank	Yes
3	JTT Computers	2	Stanisław Pacuk/Kredyt Bank	Yes
4	CLiF	8	Stanisław Pacuk/Kredyt Bank	Yes
5	Bolid	2	Jaromir Netzel, Jerzy B.	Yes
6	Drob-Kartel	2	Jaromir Netzel, Jerzy B.	Yes
7	Marcam Koegel	2	Jaromir Netzel, Jerzy B.	Yes
8	PZU	6	BIG Bank-Gdański	Yes
9	Gerard Knosowski	3	Jerzy Teichmann	?
10	Conti	6	Gdańsk authorities	Yes
11	PHU Nina	2	?	?
12	Port	4	?	?
13	Beat	4	?	?
14	Arcadium	2	Provincial SLD boss	Yes
15	SSPH	4	Jerzy Jędrykiewicz	Yes
16	Krup-Stal	4	SLD network	Yes
17	Farm Agro Planta	4	Russian oligarch	?
18	Radio Blue	5	Zbigniew Benbenek	?
19	Twoje Radio	5	?	?
20	Atrax	4	?	?
21	Griffin	7	Museum of Contemporary Art	No
22	BPH/Unicredito	6	(Identity known but not provided on record)	?
23	Pozmeat	2	Wojciech Kostrzewa/BRE Bank	?
Percent who are political thugs				52.2%

Sector Key

<u>Sector #</u>	<u>Sector Name</u>	<u>Raid?</u>
1	Agriculture, forestry and fishing (ISIS Rev. 4 Sec. A)	
2	Manufacturing, mining and quarrying and other industry (B, C, D, E)	X
3	Construction (F)	X
4	Wholesale and retail trade, transportation and storage, accommodation and food service activities (G, H, I)	X
5	Information and communication (J)	X
6	Financial and insurance activities (K)	X
7	Real estate activities (L)	X
8	Professional, scientific, technical, administration and support service activities (M, N)	X
9	Other services (R, S, T, U)	

key driving force behind this development was the successful regeneration of the communist party into a modern, social-democratic organization following its loss in the parliamentary election of 1991. Under the terms of an agreement between the government and the opposition Solidarity movement, partly-free elections were held in June 1989 that ultimately produced a government led by Solidarity. The presidential election of November 1990 went to Solidarity's leader, Lech Wałęsa. This was followed by new parliamentary elections in October 1991 which left Solidarity firmly in power and the former ruling Polish United Workers Party (PZPR) roaming in the political wilderness.

Once out of office, however, the communist party transformed itself into a viable political force by taking on the full trappings of a European social-democratic party committed to the new rules of the democratic game. Having formally dissolved the PZPR in January 1990, its leaders reconstituted it in the form of a new party, Social Democracy of the Republic of Poland (SdRP).

This marks a contrast to Slovakia, where the Communist Party never did reinvent itself. Instead, its members broke away to join myriad other parties including the HZDS, the Slovak National Party, the Association of Slovak Workers and the Democratic Union. Moreover, rather than checking government excesses from the opposition benches, the ex-communist members of these parties actually dominated a succession of Slovak governments during the 1990s. The only true communist successor party, the Party of the Democratic Left, never mounted any serious opposition to the successive Mečiar governments that were responsible for the plundering of Slovakia's choicest state assets. Instead, it occasionally flirted with the idea of joining the coalition.⁵

Like Slovakia, Poland would witness the frequent disappearance of established parties and the appearance of new ones, both on the left and the right. Even if the faces changed, however, there were clearly identifiable left and right *camps* that took turns ruling the country after each successive election. This was due to the regeneration of the communist party. The presence of a succession of powerful, left-oriented parties established a pattern whereby parliamentary oppositions could credibly threaten ruling coalitions with the threat of removal in the next elections. This is underscored by our first indicator of party competition strength, the longest length of time a ruling party spent in power. Excluding developments that occurred much later after privatization was largely completed, the most number of months a Polish ruling party managed to stay at the helm was 48. This is identical to the corresponding figure for Estonia and far lower than the 92 months registered by the longest-serving Slovak government (Table 6.3).

Instead of remaining in control through successive elections, the post-Solidarity right and ex-communist left camps alternated in power after each electoral contest in 1991, 1993, 1997, and 2001.⁶ The SdRP served as the main opposition to the Solidarity-led governments from 1991 to 1993. As Solidarity descended into internal squabbling amidst the short-term economic turmoil caused by its radical market reforms, the SdRP would come to pose a legitimate threat to its political survival, ultimately returning to power in the 1993 elections.

But the precedent of a strong opposition had now been set. It would not simply disappear once the left was back in control. In 1996, Solidarity merged with other right-

⁵ Grzymała-Busse, 76.

⁶ Ibid., 68.

Table 6.3. Party Competition Indicators

Questions per MP*		Questions per MP in Ukraine (by Year)		Longest Tenure of Ruling Party in Office During Main Era of Privatization		
Questions per MP (by Country)				Country	Longest Tenure (months)	Dates
Estonia	3.54	1998	0.40	Estonia	48	Mar. 1995 to Mar. 1999
Poland	3.78	1999	0.93	Poland	48	Oct. 1997 to Oct. 2001
Slovakia	0.94	2000	0.65	Slovakia	92	Nov. 1998 to July 2006
Ukraine	1.22	2001	0.73			
		2002	0.54			
		2003	2.08			
		2004	2.51			
		2005	4.13			
		2006	0.94			
		2007	0.08			
		2008	0.38			
		2009	0.92			
		2010	0.67			
		2011	1.43			
		2012	1.18			
		2013	1.93			
		Average	1.22			

Average Seat Share of Plausible Parties	
Country	Avg. Seat Share (%)
Estonia	1.00
Poland	0.97
Slovakia	0.81

*Average annual number of questions asked per MP

Sources: Grzymala-Busse (2007), 14; Grzymala-Busse (2003); Verkhovna Rada Department of Control (Ukraine)

wing parties to establish Solidarity Electoral Action (AWS). The AWS put up a significant threat to the SdRP government just as the SdRP had done to the right-wing coalitions of 1991 to 1993. Indeed, in the next elections, in 1997, the AWS unseated the social democrats and the roles would once again be reversed; the SdRP, which in 1999 folded itself into a new party, the Democratic Left Alliance (SLD), now became a dangerous enemy to the AWS government, ultimately ousting it in 2001. The repeated turn of fortune between left and right revealed the consistent presence of an opposition that could credibly threaten the parties in power.

To be sure, the opposition's credibility has at times left much to be desired, especially under the two social-democratic governments; while out of power, the right tended to remain in a temporary state of disarray before finally getting its act together and reestablishing itself into a viable political force.⁷ Unlike the left, which has for the most part remained under the stewardship of the SdRP and its successor, the SLD, the leadership of the right has undergone significant change over the years. The AWS suffered defections during its term in office from 1997 to 2001, with two new parties, the moderately conservative Civic Platform (PO) and the populist-conservative Law and Justice (PiS), rising from its ashes. After the 2005 elections, it would be the PiS, led by the twin-brother duo of Lech and Jarosław Kaczyński, that would play the leading role in the new government.

The PiS did not last long in power and was displaced by Civic Platform in the next elections held in 2007. Since that time, the PO has not faced the same danger of losing power that its predecessors confronted; for the first time in the post-communist era, the 2011 contest saw the same party remain in office following a parliamentary

⁷ Ibid., 69-70.

election. However, until the PO's ascendance in 2007, party competition in Poland was sufficiently robust to force a change in power after each electoral contest.

In addition to the opposition's *credibility* during the key years of privatization, the strength of party competition is also evidenced by the percentage of deputies belonging to *plausible* parties.⁸ A far greater share of Poland's MPs are members of parties that are regarded by others as potentially viable coalition partners. In Slovakia, we saw how certain parties were shunned from participation in negotiations over the formation of ruling coalitions. This was particularly true of the HZDS's partners from 1994 to 1998, who remained dependent on the senior coalition member because they had nowhere else to turn. This limited whatever tendency they might have had to keep the HZDS in check.

In Poland, by contrast, most parties were regarded as plausible partners in a variety of possible coalition alignments, at least until 2001 (after which a third of the parliament came to be composed of populist parties who were shunned by the mainstream ones). By Grzymała-Busse's calculations (which extend to 2004), 97 percent of all Polish parliamentary deputies belonged to parties considered as feasible coalition partners. Only 81 percent of their Slovak counterparts were so regarded. This puts the latter on the low end of all East-Central European countries (Table 6.3).⁹

Aside from being *plausible*, the Polish opposition over the years has proved highly *critical* of successive governments as well. According to Grzymała-Busse's data,¹⁰ Polish MPs asked an average of 3.78 questions per year through 2004. This was far higher than Ukraine and Slovakia, where deputies on average asked only 1.22 and 0.94 questions each (Table 6.3). Every ruling coalition in Poland had to put up with incessant parliamentary scrutiny not only from the opposition but its own members as well. "Opposition parties not only questioned the government constantly and publicly, but informally monitored its behavior (and gleefully informed the media at every possible turn)." In addition, coalition partners themselves monitored each other.¹¹

Because Polish governments faced stronger competition from opposition parties, they tended to restrain themselves when it came to the formal privatization process. The key mechanism by which robust competition translated into greater accountability in privatization was the reform of the Supreme Audit Office (NIK) in 1994. The driving force behind this reform was precisely the presence of a strong opposition. Unlike its Slovak counterpart, the NKU, the NIK actually possessed the power to investigate the government for malfeasance and would routinely do so in the case of many major Polish privatizations, as will become clear below. And while the Slovak NKU was controlled by the government, an informal rule emerged from the very start whereby the Polish NIK would be headed by a member of the opposition. Only the real threat of removal at the next election along with the prospect of constant monitoring in between elections could have possibly convinced a ruling coalition to accept such a strong mechanism of institutional oversight under the opposition's control.¹² The oversight powers of the legislature were enhanced in 1997 with the creation of formal parliamentary investigative commissions. These would assume prominent and high-profile roles in a series of

⁸ Ibid., 10-14.

⁹ Ibid., 14, 69.

¹⁰ Ibid., 14.

¹¹ Ibid., 68.

¹² Ibid., 104-05.

scandals over the ensuing years (particularly “Rywingate” and “Orlengate”).¹³ Although no such commission would emerge as a result of suspected privatization fraud, the prospect that it might had to weigh heavily on the minds of ruling parties.

In comparison to Slovakia and Ukraine, then, business actors in Poland had far fewer opportunities to privatize state companies through blatantly fraudulent means. That is not to say fraud was entirely absent; far from it. Successive Polish governments would employ a mix of privatization strategies, among which was a voucher component. A number of investment funds that formed to participate in voucher privatization ended up getting tunneled by their managers; “lots of state-owned capital was placed in the National Investment Funds and the managers of these funds were appointed by friends of their friends of their friends,” says Anna Marszałek, an investigative journalist.¹⁴ Direct auctions could also involve fraud, especially in the sales of smaller companies privatized by regional rather than national authorities.¹⁵

Even in major privatizations, political connections could often influence the outcome. In one scandal, a lobbyist named Marek Dochnal admitted to transferring \$250,000 to the Swiss bank account of an SLD minister to influence the privatization of Cementownia Ożarów, a cement producer.¹⁶ As we will see, other big privatizations, such as Bank Śląski, PZU, and TP SA also garnered allegations of corruption.

However, in contrast to Ukraine and Slovakia, Poland did not see the outright giveaway of the biggest state companies in fraudulent charades masquerading as competitive tenders; while political influence could tilt the balance in favor of one bidder over another, the competition was real, the prices paid substantial, and the result was rarely a foregone conclusion. Poland would rarely witness the patently undervalued and subsidized purchases of state firms that occurred in the other two countries.

Illustrating this was the fact that one of the most significant income sources for ex-intelligence officers who went into the consulting business was the sale of information on the estimated value of companies slated for privatization. The goal behind obtaining such information was to determine the appropriate amount that had to be offered to out-compete other bidders but without paying too much at the same time.¹⁷ In a context where companies could be sold for a song in exchange for bribes, this kind of information would not be expected to matter. The fact that a firm’s true value actually did factor into considerations on how much to bid suggests that political connections, even if they were important, could only go so far. This differentiates the Polish privatization process from that in many other post-communist countries.

A study of the ten largest Polish privatizations (ranked by the previous year’s revenues multiplied by the percentage sold) confirms this point. Few of these sales ended up giving major stakes to any of the plutocrats, whether political thugs, crony capitalists, or entrepreneurs. This was partly due to the use of public stock-market offerings, which opened up participation to multitudes of potential small investors. But the point is that only three of the privatizations appear to have been rigged.

¹³ Ibid., 69.

¹⁴ Interview with Anna Marszałek.

¹⁵ Interview with Respondent #71

¹⁶ “Orlen Committee: Though Now Stuck in Idle Disputes, Its Achievements in Uncovering the Truth are Undeniable.” *Polish News Bulletin*, August 4, 2005.

¹⁷ Interview with Andrzej Zybertowicz, 22 April 2008.

To be sure, this is not much different from the ten biggest Slovak privatizations, of which four satisfied one or more of the sufficient indicators of fraud noted in Appendix I. Unlike Slovakia, however, few other privatizations outside the top ten occurred through overtly fraudulent means. More importantly, the massive redistribution of assets that marked the Mečiar-backed takeovers of the Slovak privatization funds simply had no equivalent in Poland.

Because so few of the biggest privatizations occurred through blatant fraud, ambitious political thugs would have to find other ways to make it into the plutocratic elite. That they were cut off from this key potential avenue to the highest reaches of wealth goes a long way in explaining why comparatively few political thugs came to occupy the ranks of Poland's plutocrats.

Had party competition been weaker, no government would have agreed to submit to such extensive monitoring by a Supreme Audit Office under the control of the opposition. And successive governments would have been free to dispose of state enterprises through fraudulent sales to cronies instead of legitimate public offerings on the stock market. But this did not happen. Whereas at least eight of the top-ten Ukrainian privatizations were marked by serious corruption, only three were in Poland. Furthermore, as noted above, few privatizations beyond the top ten were fraudulent. Consequently, it was relatively rare for any of the state's crown jewels to end up in the hands of political thugs. This goes a long way in explaining why the Polish plutocratic elite is composed mostly of entrepreneurs and crony capitalists, who comprise between 59 and 72 percent of its ranks. The contrast to Slovakia and Ukraine is clear; there, entrepreneurs and crony capitalists together make up a *maximum* of 29 and 48 percent, respectively – and possibly as low as 18 and 33 percent (Table 3.5).

The following discussion will consider each of the ten biggest privatizations in order of size. At the top of the rankings is the June 2010 sale of 51.67 percent of Tauron, the country's second most important electricity generation firm and its largest distributor and supplier of electricity. Like most of the other privatizations on our list, the sale was conducted through a public offering on the stock exchange. While opposition parties complained that the government was using the privatization to fill "financial holes in the budget," it drew no substantiated accusations of corruption.¹⁸

The second privatization on the list was that of PKN Orlen, one of the biggest crude oil refiners in Central Europe. The sale took place through a stock market offering in October 1999. The state retained the largest shareholding with the rest distributed among small shareholders. It occurred without any incidence of obvious corruption.¹⁹

Third place belongs to the July 2000 privatization of 35 percent of TP SA, the fixed-line telecoms network provider, to a consortium of Kulczyk Holding (owned by plutocrat Jan Kulczyk) and France Telecom. Many suspected that the only value

¹⁸ B. Chomątowska, J. Piszczatowska, "Skupiamy się na Tauronie, Enerdze i PAK," *Parkiet*, 14 May 2010; "Inwestorzy indywidualni znów dostaną szansę," *Rzeczpospolita*, 19 May 2010; B. Chomątowska, J. Piszczatowska, "Oferta Tauronu może przyćmić sprzedaż PZU," *Rzeczpospolita*, 14 May 2010; J. Piszczatowska, A. Kurowska, "Tauron: Limit to 13,5 tysiąca akcji," *Rzeczpospolita*, 2 June 2010; K. Niklewicz, "Tauron zmierza na giełdę," *Gazeta Wyborcza*, 19 May 2010; "PiS: prywatyzacja energetyki - groźna dla bezpieczeństwa," *wnp.pl*, 23 July 2009 (http://energetyka.wnp.pl/pis-prywatyzacja-energetyki-grozna-dla-bezpieczenstwa,85425_1_0_0.html).

¹⁹ Lubos Vesely, "Issues surrounding the privatization of the petrochemical industry in the V4 countries," *Ruskii Vopros*, March 2003.

Kulczyk offered the French giant was his political connections, which allegedly enabled France Telecom to edge out its rival, Telecom Italia. Kulczyk actually borrowed the money to finance his part of the purchase from France Telecom itself, allowing him to earn a fortune on the transaction without investing any money of his own.²⁰ In June 2001, details surfaced of an alleged secret deal offered to the winners by the AWS-appointed telecoms minister. It committed the state to provide preferential regulatory treatment to TP SA, provide future mobile telephone concessions to the company (despite the fact that the tenders for such concessions must involve competition and had not yet been held), and guarantee the maintenance of TP SA's monopoly position until the end of 2002.²¹

Despite the clear signs of fraud, even this privatization did not amount to a Ukrainian-style giveaway. The required price was too high for Jan Kulczyk, the political thug who allegedly benefited, to participate on his own; he could only do so through a consortium with France Telecom and reportedly borrowed his share of the money from France Telecom itself. In this way, the TP SA privatization is an exception that proves the rule; political thugs like Kulczyk generally lack the capital to participate in big privatizations on their own account when the sums involved are anything more than trivial.

The fourth largest privatization was the October 2004 sale of 37.7 percent of PKO BP, Poland's largest bank, through the stock market. The Supreme Audit Office lauded it as a model of a successful privatization, although some argued that the Treasury could have gotten away with a higher public offering price.²²

Fifth on the list is the 2011 sale of one-third of coal-producer Jastrzębska Spółka Węglowa. Like most of the others, it was sold to a multitude of small investors. The only notable irregularities concerned alleged overpayments to a law firm that handled the transfer of shares to the company's employees.²³

Coming in at sixth place, Grupa Lotos was slated for privatization in June 2005. The sale of 26 percent of the oil refiner through the stock market was hailed a major success.²⁴ The seventh largest privatization took place in October 2010 when the State Treasury sold 10 percent of Polska Grupa Energetyczna, the country's largest power producer, once again in a stock-market offering. The opposition Law and Justice party

²⁰ Dariusz Malinowski, "Na czym Jan Kulczyk zarabiał najwięcej," *Gazeta.pl*, 9 November 2004 (<http://wiadomosci.gazeta.pl/wiadomosci/1,114871,2384673.html>); Elizabeth Williamson, "France Telecom, Kulczyk Holding Link Up for Joint Bid on TPSA," *The Wall Street Journal*, 26 April 2000 (<http://online.wsj.com/news/articles/SB956696937492366458>); Interview with Respondent #80; Interview with Respondents #74 and 75.

²¹ Schoenman, "Captains or Pirates? State-Business Relations in Post-Socialist Poland," 67.

²² "Debata przed każdym projektem prywatyzacji," *Rzeczpospolita*, 11 September 2004; "Wątpliwy interes narodowy," *Rzeczpospolita*, 29 September 2004; "Udało się dzięki PKO," *Rzeczpospolita*, 2 December 2004; P. Jabłoński, "Dużo miodu, trochę dziegiu w PKO," *Rzeczpospolita*, 5 October 2004; J. Majcherek, "Klucząc z Kulczykiem," *Rzeczpospolita*, 16 November 2004; M. Samcik, "Dobrze im po prywatyzacji PKO," *Gazeta Wyborcza*, 8 December 2004; *Informacja o wynikach kontroli prywatyzacji Powszechnej Kasy Oszczędności Banku Polskiego S.A.* (Warsaw: Supreme Audit Office, Department of Budget and Finance, 2006), accessed 25 May 2014 at <http://bs.net.pl/upload/File/pdf/Raport.pdf>; Prywatyzacja PKO BP pozytywna, ale..., *Wprost*, 27 April 2006.

²³ T. Głogowski, "JSW na giełdzie. Kiedy pozostałe spółki?," *Gazeta Wyborcza*, 5 September 2011.

²⁴ D. Malinowski, A. Sted, "Przed szturmem na Lotos," *Gazeta Wyborcza*, 18 May 2005.

accused the Treasury of privatizing the stake at a below-market value, but these claims were never substantiated.²⁵

The January 2013 privatization of 51 percent of Zakłady Azotowe Puławy (ZAP), a fertilizer producer, ranks at number eight. This was the second case that drew accusations of corruption. The Treasury quite deliberately sought to ensure that one company, Zakłady Azotowe Tarnów, would win. The ostensible reason for this move was to avert ZAP's takeover by Russia's Acron Group, on whose behalf former President Kwaśniewski vigorously lobbied. In the end, allegations surfaced that individuals linked to Treasury Minister Jan Grad were employed by the favored buyer, Zakłady Azotowe Tarnów.²⁶

The ninth privatization on our list, like the third, belongs to TP SA. This particular sale took place in September 2001. Similarly to the July 2000 privatizations, it garnered allegations of corruption and favoritism on behalf of the eventual winner, which once again proved to be the consortium of Kulczyk Holding and France Telecom. Media reports alleged that an employee of Kulczyk Holding bribed an individual employed at the firm that was contracted to advise the Treasury on the privatization. The goal, reportedly, was to make sure that the stake was awarded to the consortium. In December 2012, a prosecutor investigating the case was dismissed. But the Katowice prosecutor's office initiated another investigation in March 2014. It remains ongoing as of this writing.²⁷

Finally, in June 1999 an 80 percent stake in Bank Zachodni came on the auction block. In contrast to most of the other top-10 privatizations, Bank Zachodni was sold through direct auction rather than a public stock-market offering. Numerous companies associated with political thugs expressed interest, including BIG Bank-Gdański, Kredyt Bank, and BRE Bank. But it was a foreign firm, Allied Irish Bank European Investments, that ultimately submitted the winning bid of \$582 million. Allied Irish also agreed to substantial investment obligations over the ensuing years. Later on, the Law and Justice government (2005-2007) went to great lengths to find fault with the

²⁵ Szymon Łaszewski, "Akcje PGE sprzedane?," *Rzeczpospolita*, 8 October 2010; A. Łakoma, "Rząd zgarnął 4 mld zł za papiery PGE," *Parkiet*, 9 October 2010; A. Łakoma, "Po PGE pora na Eneę i PAK," *Parkiet*, 11 October 2010; C. Adamczyk, A. Łakoma, "Błyskawiczna prywatyzacja," *Rzeczpospolita*, 8 October 2010; A. Łakoma, K. Kurasz, "Wyprzedaż akcji ratuje budżet państwa," *Rzeczpospolita*, 7 October 2010; J. Dempsey, "Renewed push for privatization in Poland," *The New York Times*, 23 May 2010; K. Niklewicz, "PiS znów klóci się z Platformą o prywatyzację," *Gazeta Wyborcza*, 6 May 2010; T. Wójcik, "Prywatyzacja jako iluzja," *Gazeta Polska*, 9 December 2009.

²⁶ "Zakłady Azotowe Puławy SA - informacja o sprzedaży akcji spółki," *PAP-Emitent*, 10 January 2013; "ZA Puławy. Azoty dają za mało?," *Parkiet*, 6 March 2013; R. Gwiazdowski, "Azotowa histeria," *Rzeczpospolita*, 14 May 2013; Jerzy Dudek, "Kwaśniewski i rozmowy ws. inwestora dla Azotów Tarnów," *Rzeczpospolita*, 23 April 2013; D. Wielowieyska, "Po co Kwaśniewskiemu Acron?," *Gazeta Wyborcza*, 24 April 2013; L. Pietrzak, "Nadchodzi koniec Zakładów Azotowych w Puławach," *NSZZ Solidarność Z. A Puławy*, accessed 14 May 2014 at <http://solidarnosc-azoty.pulawy.pl/2013/01/16/nadchodzi-koniec-zakladow-azotowych-w-pulawach/>.

²⁷ I. Kacprzak, "Dymisja śledczego," *Rzeczpospolita*, 11 December 2012; "Prokuratura kończy śledztwo ws. prywatyzacji TP, Stoen i LOT," *Puls Biznesu/wnp.pl*, 5 March 2014 (http://energetyka.wnp.pl/prokuratura-konczy-sledztwo-ws-prywatyzacji-tp-stoen-i-lot,219936_1_0_0.html).

Treasury's handling of the sale but could only come up with some minor technicalities. These were, in any event, dismissed by the Supreme Audit Office.²⁸

Since the formal privatization process in Poland was far less fraudulent,²⁹ political thugs found it harder to compete in them. They tended to lack the capital necessary to finance the purchase of state firms at market prices. This was especially true for the biggest and most valuable firms, which would necessarily require substantial financial outlays in order to win. Because such companies were sold at prices approaching fair market value, only those who met the very significant capital requirements stood a chance of winning them. This meant that political thugs would mostly be cut out of the process (the exception, once again, being Jan Kulczyk, who allegedly had to borrow the money from his partner to participate in the TP SA privatization). Unless they had already managed to amass large amounts of capital through soft budget constraints and/or raiding, they could not expect to emerge victorious when up against entrepreneurs and crony capitalists.

The relative fairness of the Polish privatization process - and in particular the sales of the largest state companies - would limit the number of political thugs among the plutocratic elite compared to Poland and Slovakia (Tables 6.1 and 3.5).

Beyond the Formal Privatization Process: Soft Budget Constraints in Poland

By focusing on the role of party competition in constraining the exploitation of state resources, this study echoes a similar conclusion reached by Grzymała-Busse. She finds that robust party competition constrained the exploitation of the state by political parties in the form of ballooning bureaucracies, unregulated and/or illicit party funding, siphoning from state enterprises, and corrupt privatizations. In other words, in her view, a strong party opposition could limit the extraction of state resources not only with respect to privatizations but in a more general sense as well. This is precisely what she found in Poland.³⁰

²⁸ "Moc prywatnego banku," *Newsweek Polska*, 18 June 2006; A. Mackiewicz, "Dziesiątka chętnych do Zachodniego," *Gazeta Wyborcza*, 24 March 1999; "Kolejka do Zachodniego," *Gazeta Wyborcza*, 6 March 1999; "Government body agrees to privatize Bank Zachodni," *BBC Monitoring European – Economic*, 28 January 1999; "Zachodni na sprzedaż," *Gazeta Wyborcza*, 29 January 1999; "Prywatyzacja Banku Zachodniego pod lupą prokuratury," *TVN24 Biznes i Świat*, 4 October 2007 (accessed 12 June 2014 at <http://tvn24bis.pl/informacje,187/prywatyzacja-banku-zachodniego-pod-lupa-prokuratury,36127.html>); K. Losz, "Sprzedaż bez zgody," *Nasz Dziennik*, 6 August 2007; Alicja Kornasiewicz and Iwona Pugaciewicz-Kowalska, *Znaczenie Prywatyzacji Dla Rozwoju Polskiego Sektora Bankowego* (Warsaw: CASE Foundation, 2002). Accessed 12 June 2014 at http://www.case-research.eu/upload/publikacja_plik/bre61_3.pdf.

²⁹ Woodruff, "Property Rights in Context: Privatization's Legacy for Corporate Legality in Poland and Russia."

³⁰ Despite characterizing Poland as a case of low state exploitation, she does acknowledge asset-stripping by the PZPR in 1988-89 as well as politically-engineered state credits from the Agencja Rozwoju Gospodarczego (Agency for Economic Development) under the social-democratic government of 1993-97. But in the end, she argues, "there was little evidence that party-affiliated businesspeople could systematically profit from the ties to the state and ruling party." (205). She also notes the existence of cronyist deals between private actors, on the one hand, and state banks and debt-servicing agencies, on the other, but states that "Many of these practices rapidly ended...with the ascent to office of the opposition Solidarity after the semifree elections of 1989" (205-06). As we will see, however, corrupt relationships between parties and their business supporters were pervasive while siphoning from banks and other state

The formal privatization process may have involved far less fraud than in Ukraine or Slovakia, and can indeed be attributed to the strength of party competition. However, as this chapter will show, other kinds of soft budget constraints, both licit and illicit in nature, were far more extensive in Poland than many scholars have acknowledged.³¹ Clearly, illicit soft budget constraints were rampant, especially in the early- and mid-1990s, in the form of informal tunneling in the Polish banking system. Also, sweetheart deals in the energy sector as well as fraudulent public tenders across the economy remained a common occurrence well afterward. Where party competition did succeed in reining in state exploitation was in the realm of the formal privatization process and particularly the sale of the largest state enterprises. Such privatizations are far more visible and attract a much higher public profile than other, less formal modes of siphoning state resources. Privatization fraud is thus more likely to be effectively stymied by a vigorous parliamentary opposition than these other methods.

The pervasiveness of these other forms of soft budget constraints in the 1990s ensured that a large portion of the non-plutocratic elite came to consist of political thugs and crony capitalists. Regarding the plutocratic elite, those members who did become political thugs themselves obtained their fortunes thanks to a handful of especially lucrative opportunities for soft budget constraints (even if corrupt privatizations tended not to be a factor in these cases).

The reason for this was the particular mode by which the transition from communist rule unfolded. In contrast to Czechoslovakia, where most of the communist establishment was ousted from power in 1989-90, the Polish transition proceeded by means of a formal negotiation between regime and opposition. Despite its best efforts, the communist authorities in the 1980s were never able to completely suppress Solidarity, which had emerged as an independent trade union and political movement. Eventually, the PZPR found itself compelled to initiate negotiations with Solidarity representatives, resulting in the so-called round table talks that began in February 1989. It was these negotiations that forced the ruling communists to agree to the partly-free elections held later that year.

Łoś & Zybortowicz argue that the round table negotiations resulted in a bargain: in return for relinquishing power, the communists obtained a guarantee from Solidarity that the legitimacy of state property its members had acquired during the late communist period would not be challenged. Not only that, new and continued opportunities to benefit from soft budget constraints would remain available under the new regime, especially fraudulent and overpriced state contracts and the informal tunneling of state enterprises and banks.³² “While we have no way of verifying whether such an agreement was explicitly negotiated and achieved,” Łoś & Zybortowicz assert, “it can be argued that

entities continued well into the mid-1990s - long enough to establish scores of political thugs and crony capitalists as prominent members of the business elite. See Grzymała-Busse.

³¹ I do not dispute Grzymała-Busse's finding that the number of extra-budgetary funds and quasi-public agencies, which can be considered sources of soft budget constraints on business actors, declined from 1990-2003. For the data, see *ibid.*, 160.

³² Other scholars make a similar argument - see Jacek Wasilewski and Edmund Wnuk-Lipiński, "Poland: Winding Road from the Communists to the Post-Solidarity Elite," *Theory and Society* 24, no. 5 (1995).

*the whole process of systemic transition unfolded as if such an agreement were in force.*³³

As a guarantee to their rights to siphon state assets, Solidarity allowed former communists and their appointees to remain in key state positions after communism fell. Among the primary seats of ex-communist influence would be the Interior Ministry, the prosecutors' office, the courts, and the intelligence agencies. Former communists retained control of both the Interior and Defense Ministries for a full year following the 1989 elections. "Moreover, they retained their grip over the lower echelons of power in almost all institutions and state agencies."³⁴ During the interim period between the 1989 and 1990 elections, Czesław Kiszczak, the communist-era Interior Minister, remained in his position and ensured the passage of legislation designed to preserve the power of the secret police. The creation of a parliamentary commission to oversee the post-communist Interior Ministry, police, and intelligence agency (the Urząd Ochrony Państwa, or UOP), was delayed until 1995. A formal process to vet agents of the Służba Bezpieczeństwa (SB), the main communist intelligence agency and predecessor of the UOP, was so flawed as to render it impotent in preventing secret agents from continuing in state positions.³⁵

It is no wonder that the post-communist police and security organs would exhibit such continuity in personnel with the communist-era police state; in particular, two-thirds of officers in the post-communist UOP had served in the SB. The prosecutor's office would see a similar degree of stability; in 1990, the Solidarity-controlled Senate (the upper house of parliament) passed a deeply flawed vetting law that enabled the bulk of communist-era prosecutors to retain their positions. Meanwhile, once the social democrats returned to power in 1993, they reinstated most of the few prosecutors who had failed to pass the weak vetting process instituted under previous governments.³⁶ The courts too saw very little vetting of judges based on their past records. Throughout the 1990s, efforts to get rid of compromised judges were halted by appeals to judicial independence.³⁷

With such patrons firmly in place, the path was clear for influential officials from the old regime to hold onto the assets they had siphoned in the late 1980s as a result of soft budget constraints. The process began in 1987 and its various mechanisms were spelled out by Jadwiga Staniszkis, a prominent sociologist, in a famous 1991 article.³⁸ One method involved officials setting up private firms to buy computers from Western companies and selling them on to Polish state enterprises at a profit. Needless to say, not just anyone could set up a private computer-importing firm; only authorized, nomenklatura-owned companies were afforded the opportunity. In another scheme, well-placed communists would establish private export companies that bought goods cheaply from state firms and exported them at market prices. Previously, there had existed state-controlled Foreign Trade Centers that engaged in the same activity (more on them later). The difference now was that the profits flowed directly into the hands of the

³³ Łoś and Zybertowicz, 109 (authors' italics). Also see O'Dwyer, *Runaway State-Building: How Parties Shape States in Post-Communist Poland, the Czech Republic, and Slovakia*, 94-95.

³⁴ Łoś and Zybertowicz, 110-11.

³⁵ *Ibid.*, 125-29.

³⁶ *Ibid.*, 131-33.

³⁷ *Ibid.*, 133-36.

³⁸ Staniszkis, "'Political Capitalism' in Poland."

nomenklatura rather than the state's coffers. In addition, state farmers associations, under pressure from local party bosses, stopped serving agricultural producers as they traditionally had. Instead, they were now forced to offer transportation and trading services to private nomenklatura-owned companies engaged in cross-border trade with the Soviet Union. Such initiatives drained resources from the farmers associations, which were state-owned enterprises. To fill the gap and continue operating, they had to obtain additional state subsidies - a large portion of which went into the pockets of influential communists anyway.³⁹

In other cases, enterprise directors formed private firms which produced goods using the capital and labor of the state companies they managed. This enabled them to shift all costs onto the books of the state enterprises while keeping the profits, which were untaxed, for themselves. Well-connected companies also had privileged access to supplies, subsidies, tax breaks, and the like. Furthermore, officials in labor unions and youth organizations purchased property from the state at knock-down prices and converted it into private companies they owned personally.

For Staniszkis, this system of "political capitalism" created a privileged private sector separate from but parallel to the more traditional private sector that began to emerge in the ensuing years. Of course, it was precisely its access to soft budget constraints that gave this nomenklatura-owned private sector its privileged status.

If the negotiated structure of the transition enabled members of the nomenklatura to legalize the assets they had already obtained, it similarly ensured they would continue to receive soft budget constraints well into the 1990s. On the one hand, direct subsidies to firms along with inter-enterprise arrears declined sharply during this period.⁴⁰ However, state-owned banks would provide soft loans on a large scale well into the mid-1990s (Tables 6.4 and 6.5). Writing in 1994, economist Oliver Blanchard noted that:

The main source of hidden subsidies...has been bank loans. Given that the banking system had traditionally been a conduit for government transfers to firms, and remained state owned, many state firms were initially able to get loans to cover their losses. A current bank clean-up cum privatisation programme, applied to the major banks, has given us good estimates of the extent of bad loans. The proportion of bad loans appears to be around 40.0% of loans to state firms, or about 8.0% of GDP. Most were made in the first two years of transition. And most were made to a small proportion of firms.⁴¹

In 1994, the OECD noted the seriousness of the non-performing loan (NPL) problem. Moreover, its main source was not bad debts left over from the communist era; the value of such debts was mostly wiped out by the high inflation of the early 1990s. Rather, most NPLs reflected poor lending decisions made in the post-communist period, especially in 1990 and 1991. Unsound lending, in turn, resulted from insufficient supervision by banking regulators. Staff shortages as well as delays in amending the Banking Act limited regulatory powers. At the same time, the report noted, "a liberal licensing policy

³⁹ Ibid., 131-32.

⁴⁰ Schaffer, "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence," 98, Table 2.

⁴¹ Blanchard, "Transition in Poland," 1170.

Table 6.4: The Degree and Speed with which Hard Budget Constraints were Instituted (1-2 years into transition)

	<u>Enterprise Restructuring</u>	<u>Price liberalization</u>	<u>Banking Reform</u>	<u>Average</u>	<u>% Difference from Estonia</u>
Estonia (1993)	3.00	4.33	3.00	3.44	
Poland (1991)	2.00	3.67	2.00	2.56	-26.6%
Slovakia (1991)	2.00	4.00	2.00	2.67	-23.3%
Ukraine (1993)	1.00	1.00	1.00	1.00	-73.4%

Source: EBRD Transition Indicators
(<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

with respect to new banks...led to their rapid increase up to 1992: 60 private banks emerged during the two years after 1989, many with the minimum capital base.”⁴² By early 1994, 27.6 percent of commercial banks were loss-making while three of the big state-owned banks were in an “extremely difficult” position.⁴³ Even among the newly-established private banks, which were unburdened by bad debts from the communist period, NPLs reached 30 percent of all loans outstanding by 1992.⁴⁴

Naturally, firms controlled by influential ex-communists were among the main beneficiaries of soft loans. As we will see, such loans in the early 1990s provided fortunes to a number of lucky political thugs, particularly among the non-plutocrats. Several ultra-wealthy plutocrats, for their part, got their start thanks to soft loans and sweetheart deals in the communist period. Examples included Jerzy Starak, Zygmunt Solorz, Jan Kulczyk, Jan Wejchert, and Mariusz Walter. Fortunately for the budding political thugs, bank loans were easy to obtain. “Informally,” the OECD noted, “many banks maintained close relations with...enterprises while being unable to exercise any governance control which it was hoped a universal bank would do. Eventually, as has often happened around the world, the large debtor ‘captured’ the creditor.”⁴⁵ Balcerowicz, the much-admired architect of Poland’s market reform program, was complicit in this process while serving as Deputy Prime Minister and Finance Minister from 1989 to 1991.⁴⁶

Tax arrears were another major source of soft budget constraints. They helped keep many loss-making state enterprises in operation that would otherwise have been shut down. The majority of tax arrears accumulated in large enterprises, particularly in electronics manufacturing, fuel and energy, food processing, and light industry. Arrears also mounted in companies’ payment obligations to the state’s social insurance fund (ZUS).⁴⁷ For the purpose of this study, whether or not there was a rational social

⁴² OECD, *OECD Economic Surveys: Poland 1994* (Paris: OECD, 1994), 111.

⁴³ *Ibid.*, 105-06. Percentage calculated from Table 16 (24 out of 87 banks in 1994).

⁴⁴ *Ibid.*, 114-15.

⁴⁵ *Ibid.*, 112.

⁴⁶ Interview with Respondent #68. Balcerowicz implicitly admitted some role in the process in 1994, noting that the bloodless character of the revolution came at the price of allowing the legitimacy of property acquired by the nomenklatura before 1989 remain unchallenged. See Łoś and Zybertowicz, 124-25.

⁴⁷ OECD, 67.

Table 6.5. Non-Performing Loans as % of All Loans, 1991-2000

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Avg.
Estonia			7.0	3.5	2.4	2.0	2.1	4.0	2.9	1.3	3.2
Slovenia				13.8	9.3	10.1	10.0	9.5	9.3	9.3	10.2
Latvia				11.0	19.0	20.0	10.0	6.8	6.8	5.0	11.2
Hungary	11.0	21.0	29.6	20.2	12.1	9.0	6.6	7.9	4.4	3.1	12.5
Belarus				8.4	11.8	14.1	12.5	16.5	13.1	15.2	13.1
Croatia				12.2	12.9	11.2	8.2	12.6	20.6	19.8	13.9
Serbia & Montenegro				10.3	12.0	12.3	15.1	13.1	10.2	27.8	14.4
Bulgaria	40.0		6.7	6.8	12.5	15.2	13.0	11.8	17.5	10.9	14.9
Lithuania				27.0	17.3	32.2	28.3	12.5	11.9	10.8	20.0
Poland	17.0	27.0	36.4	34.0	23.9	14.7	11.5	11.8	14.9	16.8	20.8
Czech Republic	3.0	19.0	22.0	34.0	26.6	21.8	19.9	22.7	43.4	39.7	25.2
Romania	6.0	5.0	4.0	18.5	37.9	48.0	56.5	58.5	35.4	3.8	27.4
Slovakia	3.0	19.0	12.2	30.3	41.3	31.8	33.4	44.3	32.9	26.2	27.4
Moldova				31.0	36.0	45.5	26.0	32.0	29.3	20.6	31.5
Ukraine								34.6	34.2	32.5	33.8
Bosnia and Herzegovina									58.7	13.9	36.3
Albania					34.9	40.1	91.3	35.4	32.7	42.6	46.2
FYR Macedonia						66.1	59.5	50.3	62.6	46.5	57.0

*NPL levels reflect latest available data. In some cases (see references to Hungary, the Czech Republic, and Estonia below), data was not reported in the latest EBRD report. Thus, I relied on the most recently available report in which data was actually provided.

Sources: EBRD Transition Reports, 2002, 2003, 2004, 2005 (London: EBRD). Data for Hungary for 1993-96 comes from EBRD Transition Report, 2001. Data for Czech Republic for 1994 comes from EBRD Transition Report (1998). Data for Estonia and the Czech Republic for 1993 comes from Bert Scholtens (2000), "Financial regulation and financial system architecture in Central Europe," Journal of Banking & Finance 24 (525-553).

imperative in keeping loss-making enterprises afloat is beside the point. What matters is that the survival of such firms provided a potential feeding trough for incipient political thugs. Moreover, this situation was not helped by the administrative disarray that ruled the process for determining which firms would and would not become subject to the enforced collection of back taxes.⁴⁸

In addition to the soft budget constraints described thus far were corrupt state contracts awarded on generous terms to private companies. For example, the so-called "Warsaw Pact" was an informal group of individuals known to control public procurement in the Polish capital during the last decade. Members of the "Pact" bought political protection by doling out apartments to prosecutors, police, and other state officials and placing allies in key state positions. The Regional Audit Chamber, which

⁴⁸ Ibid.

oversees local government finances, was headed by a relative of one of the group's most powerful members.⁴⁹

The sections below will show how these trends that took shape in the late 1980s and early 1990s manifested themselves in specific cases. Beginning with the non-plutocratic elite and following with the plutocratic stratum, we will meet dozens of political thugs who rose to great wealth on the back of soft budget constraints. The provision of soft budget constraints was facilitated by dense networks linking the new business elites to ex-communist officials, especially officers and agents of the secret services. The fact that such networks proved as durable as they did was a direct result of the negotiated nature of the transition. All of the political thugs examined below forged their initial success in business out of connections to the force-wielding organs of the state. As we will see, more than a few have engaged in criminal corporate raiding.

The same feedback effects that marked the wealth-creation process in Ukraine and Slovakia were also present in Poland. As political thugs acquired greater wealth through soft budget constraints, they amassed more political influence to obtain additional soft budget constraints. Likewise, the acquisition of further wealth through criminal corporate raiding also increased their ability to secure soft budget constraints.

Sources of Soft Budget Constraints for the Non-Plutocratic Elite

One of the primary avenues for the founding of post-communist fortunes out of the assets of the communist party-state was the Foreign Trade Centers (Centrale Handlu Zagranicznego, or CHZs). Numbering in the thousands by the 1980s, these entities collectively enjoyed exclusive rights to trade with foreign states and companies. The biggest CHZs, such as Universal, Animex, Dal, Impexmetal, and Hortex, were "obviously connected to the Polish communist intelligence agencies," notes Anna Marszałek. Between 1989 and 1995, the managers of these firms set up private limited liability companies they used to tunnel CHZ assets into their own hands. Some of these private companies took the names of the CHZs they tunneled and are among the biggest enterprises in Poland today. Examples are Impexmetal, one of the country's largest metal exporters, Hortex, a leading frozen foods manufacturer, Ciech, a major chemicals producer and trader, Elektrim, the electronics conglomerate, and Budimex, a construction company. As for the CHZs themselves, some continued to exist well into the post-communist era but mostly as empty shells.⁵⁰

According to one highly knowledgeable source, the CHZs launched many of the biggest fortunes in post-communist Poland. And, because the CHZ managers who became rich from stripping their assets had been nominated to their positions by the intelligence agencies, they had to collaborate in some way with these organs. The range that such collaboration took went from offering their patrons in the secret services a portion of the profits to acting as "full-fledged, secret registered collaborators," says my respondent. "We tried to understand the sources of the key fortunes in Poland. We noticed that the sources, the roots of these fortunes, started in this domain of international trade, which was under the strict control of the intelligence services. And from this stems

⁴⁹ Zybortowicz, "Anti-Development Interest Groups (Preliminary Outline)," 83.

⁵⁰ Interview with Anna Marszałek.

the conclusion that, without some sort of compliance with the intelligence agencies, they could not pursue their business.”⁵¹

Thanks to the wealth they had stripped from the CHZs, many of their former managers and patrons were in prime positions to participate in privatizations. Usually, political thugs lack the requisite capital to compete successfully in fairly-conducted privatizations. But the substantial assets those around the CHZs had amassed through informal soft budget constraints enabled some of them to participate.⁵²

Aside from the CHZs, state debt-servicing agencies served as another mechanism for transferring communist wealth into private hands. The most infamous of these was the Fund for Foreign Debt Servicing (FOZZ), which launched the careers of dozens of political thugs. Originally established in 1985 to finance investments in the Eastern bloc, the FOZZ officially gained legal status in a law passed a week after the initiation of the round table talks in February 1989. Obtaining its capital from a combination of state subsidies, foreign currency reserves, involuntary wage deductions, and foreign trade revenues, it operated with broad autonomy under the exclusive control of the Minister of Finance. By 1990, the FOZZ had about \$1 billion dollars at its disposal. Officially tasked with servicing Poland’s foreign debt, the real purpose of the fund was to illicitly transfer assets under its control into the hands of the former nomenklatura and various criminals associated with them.

The 1989 statute conferred practically unlimited discretion upon its director, Grzegorz Żemek, to determine how to dispose of these funds.⁵³ Żemek was reportedly an officer in the Second Department of military intelligence and had responsibility for overseeing the financial dealings of the intelligence agency at Bank Handlowy’s Luxembourg branch.⁵⁴ He would later be charged in connection to the FOZZ scam and was reportedly involved in the illicit sale of arms to Iraq and Libya as well.

Despite loud warnings of “irregularities” as early as October 1989 from the audit chamber of the Ministry of Finance, the Polish government, and particularly Leszek Balcerowicz, who as Finance Minister had ultimate authority over the fund, took no action in response. Indeed, even after Żemek was dismissed by Balcerowicz in September 1990 as allegations against him mounted, Żemek continued to serve in an “advisory” capacity to the fund until his arrest a year later. “These roles enabled him to continue his previous activities,” write Łoś & Zybertowicz.⁵⁵ The formal allegations mostly centered around a \$170 million dollar special operational fund under Żemek’s control. Of this amount, a deputy prosecutor alleged that only \$60 million actually went toward servicing Poland’s foreign debt while \$100 million was illicitly used to finance dozens of businesses.

Most of this financing came in the form of cheap loans extended at eight percent per annum when the going rate at the time was 9.5 percent *a month*. Bank Inicjatyw Gospodarczych (BIG), whose director also served on the FOZZ Supervisory Council and about which we will have far more to say later, received one such loan. Additional FOZZ

⁵¹ Interview with Andrzej Zybertowicz.

⁵² For examples, see "February 1995 – Business Affairs: Wave of Buyouts Sweeps Poland." *The Wall Street Journal Europe*, February 6, 1995.

⁵³ Łoś and Zybertowicz, 165-67.

⁵⁴ “The price of Polish transformation,” G. Krumbel & Co., 15 May 2003.

⁵⁵ Łoś and Zybertowicz, 167.

funds were invested in Nywig, a company headed by Andrzej Wróblewski, a communist-era Finance Minister who would later become head of Pekao, one of the biggest state banks. Żemek was a shareholder in Nywig and Wróblewski would continue as President of the company for years. He secured Nywig's involvement in the construction of the Odessa-Brody oil pipeline along with the Jamal pipeline in cooperation with Gazprom.⁵⁶ Plutocrat Zygmunt Solorz also received start-up capital from the FOZZ. But not all of the funds were easy to trace; many disappeared abroad into a web of offshore entities belonging to "nonexistent companies," according to a 1994 report by the FOZZ liquidator.⁵⁷

Universal, which grew out of one of the biggest CHZs, received huge loan guarantees from the FOZZ. Its head was Dariusz Przywieczerski, who was among the six defendants in the FOZZ case. Another defendant, Janina Chim, served as Vice Director of the FOZZ and then took a post at Universal in 1994 - while the FOZZ investigation was ongoing. Indeed, Universal occupied a sordid niche in the story of early-capitalist Poland. TRAST, a company founded with FOZZ money by Żemek, Chim, and Przywieczerski, was able to secure the active cooperation of the Main Customs Office in its business dealings despite the fact that the FOZZ scandal had already been exposed in the press. The head of this agency, a socialist deputy named Ireneusz Sekuła, was eventually charged with wasting agency funds by making a down payment on a property that exceeded twice its actual value. The owner and seller of the property was Universal.⁵⁸

A number of state and private agencies were eventually implicated in involvement in the FOZZ affair, including the central bank, Bank Handlowy, various CHZs and their successor firms, the Finance Ministry, and hundreds of other companies from around the globe. "The people who hold the key positions at these institutions are mostly military intelligence officers according to Mr. Żemek who admitted as much during court hearings in 2002."⁵⁹

The role of the FOZZ in illicitly financing the rise of political thugs was the direct product of the negotiated transition from communist rule, which bound the interests of Solidarity and the former nomenklatura into an unholy alliance. This alliance became further entrenched as some of the political thugs to emerge out of soft financing from the FOZZ sought protection by dishing out campaign money to politicians from the Polish right. As an anonymous Finance Ministry source confirmed, "Żemek had two protective umbrellas: one provided by the old nomenklatura who tried to bolster their position and the other by new power groups who needed money for their election campaigns."⁶⁰ A massive investigation into the FOZZ affair followed in 1991. However, as Łoś and Zybertowicz lament, "most of the missing funds were unrecoverable because many of the people behind various bank accounts were unknown, several of the debtor companies were bankrupt, and the scope of many transactions was international."⁶¹ Two senior members of the Supreme Audit Chamber (NIK) who had leading roles in publicizing and

⁵⁶ "The price of Polish transformation," G. Krumbel & Co., 15 May 2003.

⁵⁷ Łoś and Zybertowicz, 168.

⁵⁸ *Ibid.*, 172.

⁵⁹ *Ibid.*, 173.

⁶⁰ *Ibid.*, 167.

⁶¹ *Ibid.*, 168.

conducting the investigation died in mysterious circumstances (one of a “heart attack” and the other in a “car accident”). Once the case went to court in 1993, one of the defendants was also killed in a fortuitously-timed car accident.

The investigators were widely criticized for their apparent lack of effort in pursuing obvious leads. Despite very clear indications of links between FOZZ insiders and the communist-era secret services, Deputy Prosecutor General Stefan Śnieżko claimed no evidence of such links had been unearthed. “Just to be sure,” he added, “we followed the only route available to us and asked the appropriate units of the Ministry of Defense and the MSW whether such links or the possibility of such links existed. The answer was negative.”⁶² Well, that certainly settles it.

The investigation and prosecution of the six defendants officially charged in connection to the scam endured years of delays. These may have stemmed, at least in part, from the fact that at least four of the eight Justice Ministers from 1989 to 1998 were later revealed to have been collaborators with the communist intelligence agencies. This could have made them reluctant to push the investigation too far for fear of being exposed as a collaborator by the former spooks who constituted the main targets. In addition to possible blackmail, there was a general atmosphere of intimidation surrounding the inquiry. It took a full year to form a team of experts to assist the investigation after scores of academic institutions, consulting firms, and other organizations refused to get involved (among the few who did agree were two individuals suspected of having links to the scheme).⁶³

Even the half-hearted official investigation concluded that a full 54 percent of transactions to which the FOZZ was a party resulted in financial losses for the fund. Although Żemek spent 15 months in prison, he was later released before the investigation concluded, officially on grounds of his poor health. “His health did not prevent him, however, from prominent involvement in various business activities,” Łoś & Zybortowicz noted.⁶⁴ For instance, he allegedly had a role in shady stock exchange transactions conducted with UOP funds - this despite the fact that the UOP (the main post-communist intelligence agency) was officially involved in conducting the FOZZ investigation.⁶⁵

Michał Falzmann, the crusading NIK inspector who died of the mysterious heart attack during the FOZZ inquiry, believed that the scheme merely represented the tip of the iceberg in a much larger operation to siphon state money through various soft budget constraints:

The FOZZ affair constitutes only a small piece of the greater whole. That greater whole...encompassed currency operations of the Bank of Commerce. [These operations] are, in turn, a small fragment of a greater picture, whose essence lies in the hidden transfer of hard currency out of Poland. The fixed exchange rate of the dollar in Poland [contributed to extremely profitable operations].⁶⁶

⁶² Ibid., 169-70.

⁶³ Ibid., 170.

⁶⁴ Ibid., 171.

⁶⁵ Ibid., 172.

⁶⁶ Ibid., 173.

The importance of the FOZZ in the history of post-communist Polish capitalism cannot be overstated. As Łoś & Zybortowicz affirm,⁶⁷ “the FOZZ scam is sometimes described as the archetype and catalyst of all economic scandals of the transformation period in Poland. The FOZZ funds were channeled to many economic ventures that later helped ex-communists to achieve economic prominence.” Before his death, Falzmann had uncovered illegal transfers to foreign bank accounts totaling \$3.5 billion. The transfers had been channeled through a CHZ. As Falzmann stated in his notes, “Polish debt is \$46 billion of which \$12 billion has to be paid to the London Club. But that debt has not been paid since 1981. The debt of Poland to the Paris Club has not been paid since 1984. There are various documents of financial transfers but, legally speaking, the debt is not being paid.” The ultimate destination of the funds that were allocated toward the repayment of the debt was precisely what fueled Falzmann’s suspicions. He added that “Between 1989 and 1991 there came to be organizations operating in Poland which are siphoning money to military circles, intelligence organizations and clandestine projects. In effect we find (1) discrepancies in payment of Polish state debt; (2) the complete and intentional disordering of Polish state financial records; [and] (3) corruption and theft taking place in order to pay for clandestine [intelligence and military] projects.”⁶⁸

The amounts involved in this and similar schemes were staggering. They go a long way in explaining the prominent role of political thugs in the Polish business world.

Aside from the CHZs and debt-servicing agencies, another source of enormous enrichment for political thugs was soft loans from the first post-communist banks. Jadwiga Staniszkis, an academic and one of the country’s preeminent specialists on the business activities of ex-communists, confirms that “The banking system was the most important axis of interests of the nomenklatura during the transformation period.” Beginning under Mieczysław Rakowski, the last communist Prime Minister, state enterprises were permitted to establish banks. Some of the major post-communist financial institutions, such as BIG, emerged in this manner. The state enterprises that set up these financial service entities eventually emerged as large “capital-commercial groups with the bank at its heart,” she adds.⁶⁹

In 1990, the National Bank of Poland, the central bank, was split into nine commercial banks. The idea was to promote competition in the banking industry. “But as bees to honey, you had people from the previous establishment coming into these newly established banks – both from the current establishment and from the previous system,” says Jacek Łęski, a former investigative journalist. He adds that the Solidarity government, entangled as it was in prior commitments to members of the former nomenklatura, had little appetite to interfere in this process.⁷⁰ According to Anna Marszałek, “From 1989-95, Poland had a very weak banking system. [The CHZs] took out credits from the state-owned banks and never gave them back...And it was easy to defraud the banks because you could claim that the failure to repay the loan was simply a

⁶⁷ Ibid.

⁶⁸ Ibid., 167-75.

⁶⁹ Rafał Kasprów and Jacek Łęski, “BIG, czyli jak powstawała czerwona pajęczyna” *Życie*, 30 April-1 May 1997.

⁷⁰ Interview with Jacek Łęski.

result of a bad business decision and so forth. But, of course, the officials at the bank assisted in this and were paid for their help.”⁷¹

Once the former communist party returned to power after the 1993 election victory of the SdRP, the law was changed to make it much more difficult to prosecute these criminals. Investigators were now required to calculate the precise amount that was allegedly stolen. Few investigators had the capacity to do this. The result was that “all these cases were forgotten.” In one instance, the Deputy Chairman of a large bank was physically threatened not to disclose to investigators any information regarding bank fraud by the directors of a state-owned enterprise.⁷²

One of the biggest state banks, Bank Handlowy, which played a central role in the FOZZ affair, was practically bankrupt by 1989 as a result of fraudulent loans.⁷³

Another bank that sourced a number of illicit fortunes was PKB, the second private bank ever established in post-communist Poland.⁷⁴ It is a classic case of low-level criminals plucked from obscurity to become prominent political thugs thanks to generous soft budget constraints.

Its official founders were Janusz Aleksandrowicz and David Bogatin, two criminals with communist links. Aleksandrowicz was an “entrepreneur” in Lublin during the 1980s and was well-connected with the local communist establishment. He reportedly did jail time once, which is how his relationship with the SB intelligence agency supposedly began. Bogatin’s background is “worthy of a film,” according to Jacek Łęski, the reporter who broke the PKB case. He was a Soviet citizen who emigrated to the US in the 1980s. The fact that he emigrated means he either fled the Soviet Union or came to the US with official Soviet backing. Given his previous role as a Soviet military adviser in Vietnam, the latter scenario is more likely. While in America, he and several other Russians hooked up with a New York mafia family in a tax-evasion scam involving fuel transactions. When some of them attempted to strike out on their own, the mafia took out contracts on their lives. Of the seven Russians who tried to break away, only three survived. One was severely wounded and would spend the rest of his life in a wheelchair. Another became a police informant and went into witness protection. The third was Bogatin, who was arrested but skipped bail and fled to Vienna.

“When he ended up in Vienna after running away from the States he was a pretty poor guy,” says Łęski. “He had nothing. He had problems with the prosecutors, he had problems with his situation, and for him to end up in Poland as this immensely wealthy guy, this wealthy investor, well, it was a fairy tale.” The fact that he managed such a feat garnered suspicions that he was backed by financing from the secret police. Given the connections between the SB and the KGB (recall his prior role in Vietnam), there was a “common denominator” that helps explain Bogatin’s involvement in the PKB scam. Furthermore, the shady criminal backgrounds of the two official PKB founders meant that they could be easily blackmailed into perpetual compliance and secrecy.

⁷¹ Interview with Anna Marszałek.

⁷² Interview with Anna Marszałek. For more on this phenomenon, see Dudzinski and Szymkiewicz, 228-30.

⁷³ Interview with Respondent #68.

⁷⁴ The following information on PKB and the subsequent bailout of the banking system comes from an interview with Łęski, except where otherwise noted.

Both men were being groomed by the SB to invest money on behalf of its former top-level officers, Łęski believes. At the time, Aleksandrowicz was a shareholder in a frozen food producer and his mistress had a leading role at the Lublin branch of PKO, a state bank. Thanks to his connections at the bank, he was able to arrange a loan to the frozen food company to purchase equipment. “That money was then taken in a suitcase to Vienna in the form of cashier’s checks, which was legal at the time,” Łęski says. Then Bogatin brought the money back into Poland under the guise of a wealthy foreign investor.

The two established PKB in January 1991. Considering their humble origins, the notion that Aleksandrowicz and Bogatin were the real shareholders strains credulity; they likely served as the front men for powerful ex-communists. Indeed, “former regime officials had to find a new place for themselves, and a bank was the perfect place for them,” Łęski says. PKB ended up employing most of the ex-communist officials from Lublin.

Another branch was set up in Warsaw under the stewardship of Wiesław Kaczmarek, who would go on to serve in prominent ministerial positions under both social-democratic governments. Kaczmarek’s decisions in his various official roles have at times benefited political thugs with links to the old regime. In one case, degenerates named Zygmunt Nizioł and Włodzimierz Wapiński who were connected to the Democratic Left Alliance (SLD) won a contract from the health ministry to build a plasma fractionating laboratory. Wapiński was a close friend of President Aleksander Kwaśniewski while Nizioł “was most certainly an officer of the secret services,” says Łęski, who was the first to report on the affair. Nizioł had previously been banished to a diplomatic job in London after a contract he won to supply equipment to the military erupted into scandal. The technology involved in plasma fractionating is highly complicated and neither of the investors had any qualifications remotely adequate to make any use of it. “It as if the three of us here said we were going to manufacture F-16s,” Łęski says. No bank was willing to lend them the money to build the factory - that is, until Kaczmarek’s ministry decided, against the strong doubts of his staff, to guarantee the investment. Needless to say, the factory was never built, production never began, and the \$27 million loan vanished into thin air. “So the state started repaying the loans,” Łęski recounts. “Poland can afford \$27 million. And in Poland there are many businesses like this.”

Getting back to PKB, the bank quickly ran into serious financial difficulties. Various irregularities, including a fictitious capital increase and the theft of depositors’ money through fraudulent loans, were revealed in a *Gazeta Wyborcza* article by Łęski in 1992. Following its publication, PKB immediately collapsed amidst a panic by depositors and the bank was placed under forced administration by the NBU. Bogatin was extradited back to the US, where he was wanted on charges relating to the fuel scam, and eventually served time in prison.⁷⁵

According to Łęski, who did some of the most extensive reporting on shady dealings in the Polish banking sector, by 1994 the takeover of the big state banks by the communist political establishment was largely complete. “But they did not know how to manage those banks,” he says. After he broke the PKB story and panicked customers

⁷⁵ Piotr Głowacki, “Krań afery Bogatina,” *Gazeta Bankowa*, 29 November 2012 (http://www.skarbiec.biz/gospodarka/29_11_2012.htm).

began lining up outside the bank, top officials at the National Bank of Poland (NBP) started to panic. Łęski could not understand why; after all, who cares about this one little bank in Lublin? However, after obtaining a confidential official report revealing the level of bad debts in the banking system to exceed 70 percent, he did understand; “they knew about the level of bad debts in other banks [besides PKB] as well, and they were afraid of a domino effect.” Łęski himself estimates that half the non-performing loans in the banking system simply represented giveaways to insiders and cronies and were not recoverable at all. “They basically treated it as their personal stash. And since it’s theirs, they’re going to give it out to their own people. They’re building their own companies and they have an excellent starting point in terms of building a new political system. And things were just great.”

But by 1994, the country’s top banking regulators realized that the whole system was about to collapse under the weight of these bad loans. Hanna Gronkiewicz-Waltz, chief of the NBP, decided to take action and engineered the sale of most of Poland’s bankrupt state banks to foreigners. “That was the only way out,” Łęski says. “And that’s why the Polish banking system is now practically entirely foreign-owned.” Nevertheless, all the sales came with conditions. “If, say, Citibank wanted to enter the Polish banking sector, they’d be informed that ‘we have this skeleton in the closet, so please accept it’...And that’s how Citibank, for example, had to take on Bank Handlowy.”

Thanks to Gronkiewicz-Waltz, the days when the biggest Polish banks could be freely used to extend soft loans to cronies are now over. There are exceptions, to be sure, particularly at the two remaining state-owned banks, BGZ and PKO BP (not to be confused with PKO SA, or Pekao, which is owned by Italy’s Unicredito). Ruling parties still seek to place their representatives on the boards of the two banks precisely to ensure that their business allies can obtain soft loans. But the overall problem is a shadow of what it once was. Nevertheless, in one key sense, the cleanup under Gronkiewicz-Waltz could not erase the damage that had already been done; by extending cronyist loans with abandon, the state banks had substantially and irreversibly helped finance the establishment of a powerful class of political thugs and crony capitalists. As the bank overhaul got underway, such actors were in a position to start shifting their efforts away from soft financing to acquiring other kinds of soft budget constraints. These ranged from the informal tunneling of companies to fraudulent state tenders and, in some cases, corrupt privatizations, as we will see in due course.

Socialists and Spooks

While many state banks were failing under crushing liabilities to political thugs, private and semi-private banks controlled by some of these political thugs were flourishing. One of the most notable was Bank Inicjatyw Gospodarczych (BIG), established a mere three days after the defeat of the ruling communist PZPR in the June 1989 elections.⁷⁶ In theory, the bank was two-percent owned by private individuals with the remainder owned by various state institutions. The reality was somewhat murkier. An anonymous representative of the communist regime who participated in the round table negotiations shed some light on the rationale behind BIG’s establishment: “The [regime]

⁷⁶ Except where otherwise noted, the following discussion on BIG comes from Kasprów and Łęski, “BIG, czyli jak powstawała czerwona pajęczyna.”

transformation required that circles related to the PZPR create a financial system which could ensure the maintenance of its economic power and establish a basis for new business. Many people from the financial establishment of the PRL [People's Republic of Poland] were interested in founding a bank over which control would lie in the hands of trusted activists.”⁷⁷

According to Rafał Kasprów and Jacek Łęski, who in 1997 published a famous exposé of the bank, “The founders of BIG were members of the PRL financial establishment, private individuals who at the same time had wide access to state funds.” The first private shareholders represented a who's who of the communist nomenklatura: Aleksander Borowicz, a top-level official in the Council of Ministers; Anatol Adamski, President of PZU, the state insurer; Andrzej Cichy, General Director of the state postal and telephone monopoly; Andrzej Olechowski, the central bank chief and future Finance Minister; and the managers of various CHZs and other state-owned firms. Not coincidentally, most of the state companies headed by BIG's private shareholders themselves bought major stakes in the new bank. Jerzy Urban, the spokesman for General Wojciech Jaruzelski, Poland's military ruler during the 1980s, was also among the first to purchase shares in BIG.

Another founding shareholder was, of all things, the Foundation for the Development of Sailing (Fundacja Rozwoju Żeglarstwa), a semi-public organization set up in 1989 by “sailing buddies” Mieczysław Rakowski (a former communist party official with a major role in suppressing Solidarity), Bogusław Kott (President of BIG) and Aleksander Kwaśniewski (the future President of Poland). “It is not known why a foundation using among other things public funds invested in shares of a newly established bank,” write Kasprów and Łęski. Kott himself had held supervisory positions in the 1980s at various scandal-plagued companies and stage agencies, including the Finance Ministry (consumed by an import credit scandal) and Towarzystwo Handlowo-Uslugowe (illegal gun running).

“It was a bank founded by a group of friends,” explained Andrzej Olechowski, touting the bank's entirely innocent origins.

“To this day,” Łęski says, “when you show the list of shareholders and stakeholders in this bank - and I show young journalists this list - they can't believe it: former President Kwaśniewski, former Prime Minister Leszek Miller, Jerzy Urban, former Minister of Foreign Affairs Andrzej Olechowski,” and the list goes on.⁷⁸

“BIG is becoming stronger very quickly, but it is difficult to explain this fact on a purely economic basis,” went an elegantly understated observation by a Polish weekly in 1996. From a comparably modest starting capital of one billion zlotys in 1989, BIG received trillions of zlotys in additional capital infusions from state companies over the ensuing years - despite the fact that these firms were in serious financial difficulty themselves. For example, PZU, the state insurance company, had losses of one trillion zlotys in 1990. Yet it still managed to deposit PLN65 billion in BIG that very same year, with no interest to be paid until years afterward. That deposit alone was worth 65 times BIG's entire net worth. Also in 1990, the FOZZ deposited PLN160 billion, 100 billion of which BIG promptly transferred - without any formal authorization from the FOZZ - to

⁷⁷ Quoted in Ibid.

⁷⁸ Interview with Jacek Łęski.

PKO, another bank. The transaction “provided unjustified benefits for BIG SA” totaling at least PLN1.8 billion, according to a subsequent inquiry by the NIK.

A survey of some of the companies that served as BIG’s founding investors illustrates the critical role soft budget constraints played in the emergence of the post-communist business elite. One of these was Transakcja, which became a ten percent shareholder. Transakcja was initially set up with financing from a half-dozen official organs linked to the communist party structure. However, following the change of regime, ownership of the shares transferred to the SdRP, the communist successor party. Representing SdRP’s interests in the company was future Prime Minister Leszek Miller. Transakcja became a partner of the SdRP in a wide range of business enterprises. As for BIG, Transakcja sold its shares in the bank for PLN1.7 billion just as rumors began mounting of an impending takeover by the State Treasury. The proceeds from the sale represented more than a ten-fold return on Transakcja’s investment.

Another founding shareholder in BIG was Interster, itself a major beneficiary of cheap state financing. Among the shareholders in Interster was the ever-enterprising Foundation for the Development of Sailing, another BIG investor. Interster, which would become well-known for its links to social-democratic politicians, received billions of zlotys in preferential loans from the Office for Physical Culture and Sports which, like the Foundation for the Development of Sailing, was headed by future President Kwaśniewski. According to Kasprów and Łęski, “It can hardly be believed that Kwaśniewski did not participate [as a shareholder] in the establishment of Interster, as the company was founded and received its considerable assets thanks to the institutions he ran.”

Other nomenklatura-linked shareholders in BIG included Polisa, which counted among its own shareholders several state companies along with the wives of two major social-democratic politicians, Józef Oleksy (Prime Minister from 1996-97) and Aleksander Kwaśniewski (President from 1995-2005). After investing nearly 100 billion zlotys in BIG, Polisa ran into severe financial difficulties by early 1995 and was subsequently purchased by BIG itself. BIG was able to make the purchase on preferential terms as a result of a decision by the Securities and Exchange Commission that barred Polisa from selling shares in a public offering.

Another BIG shareholder was Universal, named after the CHZ out of which it grew. Universal exploited its privileges as part-owner of the bank to grant huge loans to itself. It was headed by Dariusz Przywieczerski, one of the defendants charged in the FOZZ case. Przywieczerski, along with BIG’s President, Bogusław Kott, each held positions on the supervisory board of the other’s company. One of the loans that BIG extended to Universal totaled PLN300 billion, which amounted to 87 percent of the bank’s entire equity at the time.

In 1993, BIG was named the “Best Polish Bank” by Britain’s *Euromoney* magazine.⁷⁹ The particular methods on which *Euromoney* relied to reach this conclusion are unknown. In any event, by this time BIG was just getting started. Once established, the bank continued to access cheap state financing, mostly in the form of new emissions of shares that were bought by the state companies comprising its main shareholders. This is a perfect example of the feedback effects between soft budget constraints and the rise

⁷⁹ See Bank Millennium website: <http://www.bankmillennium.pl/en/about-the-bank/about-the-bank/history/>

of political thugs; the political thugs around BIG were able to translate the wealth they obtained during the bank's early days into increased political influence, which they then used to obtain still more state assets through soft budget constraints. In particular, BIG was subsequently able to mount an epic series of corporate acquisitions, most notably of the much larger Bank Gdański. BIG purchased Bank Gdański in a highly questionable privatization (after which it would change its name to BIG Bank-Gdański). Not only was Bank Gdański worth far more than BIG itself, but a survey at the time found that six times as many Polish companies would rather do business with Bank Gdański than with BIG. Previous surveys consistently ranked Bank Gdański as among the country's top five banks while placing BIG in the bottom five.

Following its unlikely acquisition of Bank Gdański, BIG bought the state-owned Łódzki Bank Rozwoju (ŁBR), which counted among its employees many of the key figures in the FOZZ scandal. Created by the communist party a few months before the establishment of BIG, ŁBR "quickly slid into trouble," wrote Kasprów & Łęski, "having granted loans which it could not collect later. BIG carried out reforms at ŁBR and took control of the bank on beneficial terms granted by the [central bank]." BIG also purchased Polisa, another nomenklatura-controlled firm, also on questionable terms granted by the SEC. Polisa had run into financial difficulties in 1994 after an ill-fated PLN100 billion purchase of shares in BIG itself.

These acquisitions were helped along by BIG's solid connections at the central bank and particularly what Kasprów and Łęski term the "skillful staffing policy of Bogusław Kott;" two members of the central bank's board were later revealed to have close ties to BIG. Adam Glapiński, a former minister in the Solidarity government, noted in 1997 that "So far there has been no government so strong as to oppose the people connected to the banking sector. Their strength lies in their ability to overturn governments, and not vice versa." He also believed that the flood of nomenklatura into the banking sector was a direct result of the round table negotiations and was tacitly approved by successive post-communist governments.

In sum, BIG rose to become one of Poland's most successful banks almost exclusively on the basis of soft budget constraints. It should thus come as no surprise that the bank has used the same connections that ensured its access to state resources to assist it in criminal corporate raiding.

By the mid-1990s, most large Polish banks were in serious trouble due to all the soft loans they had extended to the emerging class of political thugs. Seeing an opportunity, Western banks began swooping in to take over the financially-distressed banks at cheap prices. Among these prospective buyers was Deutsche Bank.⁸⁰ Unlike most other Western banks, however, its acquisition effort would ultimately fail. The reason was simple: the target of this campaign was BIG Bank-Gdański. The principals of the other banks too had little enthusiasm for selling out for a song to Western institutions, but BIG Bank-Gdański was not other banks. "Deutsche Bank went about the takeover in the lawful, West-European way, without doing the proper investigating," said Kasprów. "They did not take into account what kind of people held accounts there, who the bank was financing, who controlled the bank, and what kinds of political connections it had." He added that this was the first time in post-communist Polish history that decisions made at a legitimate shareholders meeting were actually blocked by judges and

⁸⁰ Non-plutocratic raid #1 (NPR #1)

politicians. The attempted takeover, which dragged on from 1998 to 2000, featured two conflicting supervisory boards and managements, each of which claimed control of the company.⁸¹

Another political thug who got his start in the state-owned banking sector is Stanisław Pacuk. Pacuk was an official at the National Bank of Poland during the communist period but left in 1990 to found Kredyt Bank, becoming its first President. Kredyt Bank quickly became one of the country's largest banks.⁸² Its meteoric rise was fueled by soft loans secured through political connections. During his tenure at Kredyt Bank, Pacuk helped engineer the takeover of several other banks, including the state-owned Polski Bank Inwestycyjny (PBI) in a questionable privatization. PBI was one of only two state banks (along with Bank Gdański, which would later be acquired by BIG) that were not formally incorporated during the reorganization of the banking sector at the end of communist rule. Both were eventually privatized in rigged sales. "Basically," one of my sources explained, "a bunch of guys sat around the table and were splitting things up. So Mr. Kott got Bank Gdański and Mr. Pacuk got PBI."⁸³

Kredyt Bank also emerged as the main beneficiary in the suspicious bankruptcy liquidation of the Marcin Kasprzak Warsaw Radio Factory in 1994 (because the company was state-owned, this does not count as a raid). After falling into serious financial trouble in the early 1990s, the factory underwent a remarkable turnaround over the next few years, spearheaded by its managers. "We reduced employment by two thirds, gave up the production of audio devices and began producing for the army, and were ready to obtain help under the debt removal law," said its director, Marek Łotocki. Most importantly, it finalized a deal with Bank Handlowy, its largest creditor. That should have easily paved the way for the company's re-emergence from bankruptcy.⁸⁴

What it did not count on was the bankruptcy judge, a petty Dickensian schoolmaster-type named Dariusz Czajka. In July 1994, just as the factory was finalizing the rescue deal, judge Czajka introduced a new petition for Kasprzak's bankruptcy. The author of the petition was another company undergoing bankruptcy, and the judge in that case also happened to be Czajka. His position gave him ultimate authority over whether or not such a bankruptcy petition would be filed. Because of the clear conflict of interest, Kasprzak managed to have Czajka replaced by another judge, Sławomir Góralski, who dismissed the petition. But Czajka quickly got himself reappointed to the panel and managed to secure Góralski's approval to put Kasprzak into liquidation.⁸⁵

Far more valuable than the company itself was the valuable Warsaw real estate on which it resided, and the eventual buyer of that real estate was Pacuk's Kredyt Bank. The bankruptcy trustee and his deputy, both appointed by Czajka, were subsequently hired by Kredyt Bank. So was judge Góralski, the one who made the critical decision to reinstate the bankruptcy petition after having previously dismissed it. He now took a post in Kredyt Bank's debt recovery department at a salary several multiples above his earlier earnings as a judge.⁸⁶

⁸¹ Interview with Rafał Kasprów.

⁸² "Stanisław Pacuk – sylwetka," *Gazeta Wyborcza*, 27 January 2003.

⁸³ Interview with Respondent #78.

⁸⁴ Radosław Omachel, "Sad Najwyższy uchylił glosna upadlosc CLiF," *Puls Biznesu*, 19 May 2003.

⁸⁵ Ibid.

⁸⁶ Ibid.

As should be abundantly clear by this point in the dissertation, it does not take much of a stretch to go from stealing state assets to stealing private ones. Indeed, Pacuk and Kredyt Bank have allegedly profited from several criminal corporate raids and have attempted numerous others. In 2001, a group linked to Pacuk was attempting to buy up shares in the Lublin Brewery. However, another businessman, Hubert Gierowski, was trying to take over the brewery at the same time. He managed to buy up a majority stake in the company before Pacuk's faction did. "That's when all hell broke loose," says my source, "with the prosecutor's office, the Finance Ministry, the Lublin police, with accusations of fraud, and so on and so forth. Of course the idea was to take away the controlling stake from this other guy." Gierowski assigned power of attorney to a representative and fled the country in the meantime. This proved to be a smart move, as he soon became the subject of an arrest warrant by the Lublin police. His lawyers eventually managed to show that the warrant was not based on any credible evidence. But until that point the warrant remained outstanding and a matter of public knowledge. As such it had a damaging effect on Gierowski's other businesses.⁸⁷ "It was nightmarish for him," recalls my source.⁸⁸

Another raid blamed on Kredyt Bank targeted JTT Computers.⁸⁹ In 1999, MCI Management bought JTT. At the time, JTT was Poland's second-largest manufacturer of PCs and computer hardware after Optimus, another company that would be destroyed in a criminal corporate raid (more on that later). In December 1999, the MCI-appointed CEO of JTT was suddenly charged with tax fraud and the company was ordered to repay PLN10.5 million in back taxes stemming from allegedly fraudulent VAT refunds. It eventually won its three-year battle with the Treasury but went bankrupt in the process. A court ordered the Treasury to pay PLN28.8 million in compensation to MCI, but that came years afterward and offered little consolation. Indeed, the company might have saved itself from liquidation but for the interference of Pacuk's Kredyt Bank. "JTT's management has announced several times that Kredyt Bank is responsible for finishing off the company by illegally drawing money from its account," according to one news report. "This bank made it impossible to strike a deal through its illegal activities and postponing procedures," fumed JTT's President, Janusz Krasnopolski. While JTT was in bankruptcy - and after it had already won its fight with the Treasury - Kredyt Bank had a bailiff freeze PLN20 million of the company's funds, which prevented a deal with creditors to save the firm.⁹⁰

Kredyt Bank also emerged as the major beneficiary in the bankruptcy of CLiF.⁹¹ CLiF was a thriving auto-leasing company and a star performer on the Warsaw Stock Exchange in 2000. Then, suddenly, its banks simultaneously cancelled their credit agreements with the company and called in their loans. One of the lenders was Kredyt

⁸⁷ NPR #2

⁸⁸ Interview with Respondent #78.

⁸⁹ NPR #3

⁹⁰ "JTT Computer faces closure," *Polish News Bulletin*, 2 June 2004; "PC maker JTT fails to strike deal with creditors, heads for bankruptcy & liquidation," *Interfax Poland Weekly Business Report*, 31 May 2004; "Bank Seizes PLN20.7m Recovered by JTT from Tax Authorities," *Polish News Bulletin*, 23 April 2004; Julie D. Goldman, "JTT hits back at Wroclaw Police charges that it avoided VAT," *Warsaw Business Journal*, 27 March 2000.

⁹¹ NPR #4. The following information on CLiF comes from Omachel, "Sad Najwyzszy uchylil glosna upadlosc CLiF."

Bank. Although CLiF still had enough cash to pay its debts, the loan cancellations jeopardized its ability to buy equipment and vehicles. Soon after the debts were called in, Dariusz Baran, CLiF's CEO, received a visit from representatives of Kredyt Bank offering to buy the firm for 20 percent of its current stock market price. "I got an offer I couldn't refuse," Baran laments. But he did refuse, with the result that Kredyt filed a petition for CLiF's bankruptcy.

The bankruptcy judge appointed to handle the case was none other than Dariusz Czajka, who had helped out Kredyt Bank in 1994 by liquidating the Kasprzak Warsaw Radio Factory. Czajka promptly declared the firm bankrupt and appointed as bankruptcy trustee Sławomir Zaborowski, the same deputy trustee from the Kasprzak case who was later hired by Kredyt Bank. Zaborowski immediately transferred one million zlotys of the company's cash into accounts controlled by Kredyt Bank - despite the fact that the law prohibited any such transfers before the bankruptcy court finished compiling a complete list of creditors. He then decided to have a little fun with a luxury Audi 8 belonging to CLiF, taking it out for a drive after a raucous bout of drinking and crashing it.

In all, Kredyt Bank would receive hundreds of millions of zlotys from CLiF courtesy of Zaborowski in his role as bankruptcy trustee. Zaborowski badly mismanaged the firm in other ways as well, allowing its tax payments to lapse into arrears and appointing his friend Tomasz Palaszek, the lead trustee in the Kasprzak case, to a lucrative do-nothing post at the company. Both men continued to serve as bankruptcy trustees while working at Kredyt Bank and its subsidiaries. "Everyone, including court presidents, prosecutors, and the Ministry of Justice accepted the fact that both of Czajka's bankruptcy trustees did private business with banks - to be precise, with one bank which for ten years had been buying out properties that belonged to insolvent companies that were liquidated by the two gentlemen by virtue of the law," an article on Czajka's questionable bankruptcies reported.

Meanwhile, thousands of CLiF customers financing vehicles and machines they had purchased from the firm were brusquely told they would have to buy the products outright or return them to the company. Enraged, they began seeking out Warsaw law firms to represent their interests and obtain compensation. "After their initial explanations [the clients] were only asked one question, mentioned as if in passing," said Andrzej Sawicki, who sought to organize a rescue of CLiF. "'Who is in charge of the case?' The name Dariusz Czajka stopped any other considerations. 'We're very sorry but it's not doable.'" In March 2002, CLiF lost its appeal and vanished forever from the Warsaw Stock Exchange.

Finally, Baran, CLiF's beleaguered CEO, got his case heard before the High Court, which ruled in May 2003 that both the first- and second-instance bankruptcy judges committed gross violations of the law in liquidating the publicly-held company. Nevertheless, by that time its customers, contractors, and banks wanted nothing to do with it anymore. To make matters worse, soon after the High Court reversed the lower-court rulings, Kredyt Bank removed several million zlotys from CLiF's account at the bank, officially for "repayment" of a debt. In 2002, newspaper reports revealed that judge Czajka had previously benefited from a sweetheart business deal with Kredyt Bank. He was reprimanded for this by a disciplinary court although was permitted to

remain in his position. “I have nothing to be reproached for and I am intending to appeal this judgment,” Czajka protested.

In addition to the banks, PZU, the state insurer, also spawned a number of political thugs on the back of sweetheart deals. Preston Smith, an American investigative journalist who lives in Poland, published a series of exposés on asset-stripping at the insurer. Thanks to documents he obtained from the bitter ex-wife of a company insider, he was able to detail the complicated web of offshore entities used to siphon money from the firm. The destination of the funds were accounts controlled by former PZU President Władysław Jamroży and former PZU-Życie President Grzegorz Wiczerzak. Both ended up doing jail time for their roles in the affair but were later released and never convicted. To funnel the money offshore, they relied on the assistance of a “Third Man,” as Smith titles one of his articles. The third man was a Canadian Pole named Andrzej Perczyński who previously did jail time in Switzerland before getting hired at PZU.⁹²

While President of PZU from 1997 to 2000, Jamroży oversaw a project to construct the PZU Tower in Warsaw. He “managed to build a building through a team of developers, landowners, and contractors as cheaply as he could, then see it sold back to PZU at the highest unofficial price possible,” writes Smith. “The difference, which may have been between \$30m and \$55m, would be diverted into a spider-web of companies that eventually would send the money to offshore trusts and bank accounts – in other words, right back into his pocket.” The payments for the tower’s construction went to a company called BRC Holding and a number of other entities linked to Perczyński. Through a series of subsequent transfers, the money ended up in offshore trusts and bank accounts operated by the Warren Trustees, the beneficiaries of which were Jamroży and Wiczerzak along with Perczyński. Another offshore entity, Portland Trust, had as its sole beneficiaries Jamroży’s daughter and sister. A third trust, Fountain Holding Limited, listed Wiczerzak as having full rights to make unlimited withdrawals from its accounts without the approval of the other beneficiaries. Meanwhile, “the same parties setting up offshore bank accounts for Jamroży and Wiczerzak [that is, BRC Holding and other Perczyński-linked companies, along with Warren Trusts] happened to be taking PZU money for developer’s fees, finders fees and reinsurance and insurance fees going to Warren Trustee members.” From the perspective of PZU’s shareholders, BRC was a rather peculiar choice to lead the construction project. “Interestingly,” Smith notes, “BRC Holding did nothing from 1991 to 1996, when suddenly the company was chosen to develop the PZU Tower.”⁹³

The siphoning of money from PZU was hardly limited to the construction of its Warsaw headquarters; illicit soft budget constraints provided courtesy of the firm began in the early 1990s. Over the years, PZU has been a feeding trough for members of the Polish elite. It was a particularly lucrative one given its control over most of the property-casualty insurance market and half the life insurance market. Legions of Polish politicians and their cronies have siphoned assets from the company through illicit soft budget constraints, including cronyist contracts for marketing, investment services, real estate, and the like.⁹⁴

⁹² Preston Smith, “The Third Man,” *Poland Monthly*, October 2003.

⁹³ Ibid.

⁹⁴ Adrian Leonard, “Poles Apart: Poland’s government is rocked by efforts to take the monopoly insurer PZU private.” *Leaders Edge Magazine*, June 2005.

In another article, Smith details how the Warren Trustees Group, run by British National Alan Evans, facilitated the illegal transfer of millions of dollars out of the insurer and into the pockets of various PZU officials. These transfers began in the early 1990s and continued through 2004, when the article was published. The officials who benefited included Jamroży and Wiczerzak, former PZU President Krzysztof Jarmuszcak, former PZU Vice President Krzysztof Baca, PZU board member Janusz W., and former PZU President Roman Fulneczek. Under Evans, Warren Trustees set up a complex web of offshore trusts and accounts in Jersey for the purpose of siphoning cash from PZU. The money ended up in the hands of these officials along with a number of other Polish nationals.⁹⁵

It started as early as 1993, when PZU was headed by Jarmuszcak and Baca, and continued thereafter. A number of trusts were established for the various PZU officials, each of whom received debit cards from Western banks to draw on these funds. The trusts had names like Global Financial Investment Holding Limited, European Risk Management Consultants Limited, Allied & Provincial Limited, Narai Limited, Pinnacle Trustees, Linfield Consultants Limited, Ellenton Investments Limited, Fountain Trust, Hestia, and Stofield Developments. The establishment of offshore accounts was illegal in Poland until 2002 (“and technically even now,” says Smith), and so their existence was kept secret by Warren Trustees.⁹⁶

In all, Jamroży spent three years in prison while authorities investigated allegedly fraudulent overpayments for real estate by PZU which benefited him personally. In addition to tax evasion, Wiczerzak too did jail time for alleged actions that adversely affected PZU-Życie. The tax evasion charges were later dropped due to insufficient evidence. Despite the stories that appeared in *Poland Monthly* and *Rzeczpospolita*, the Jersey authorities did strikingly little to investigate the allegations (which is par for the course in such offshore secrecy jurisdictions). But they also disclosed that the Polish authorities never contacted them for information or assistance in their own investigations. The only actions taken in the wake of the newspaper exposés was a gag order on Smith issued after the publication of “The Third Man.”⁹⁷

It was not long after the other alleged criminals departed PZU that another ex-communist political thug arrived on the scene. Jaromir Netzel became Chairman of the Board in 2006 after being nominated by the government. Within days, an article by Bertold Kittel appeared in *Rzeczpospolita* that detailed his shady past. In particular, it revealed Netzel’s connections to one Jerzy B., another ex-communist dark operator then on trial for embezzlement and money laundering. Kittel discovered that Netzel had played roles at a number of companies run or owned by Jerzy B. beginning in the 1980s. The relationship between the two nicely illustrates how political thugs rise to wealth through soft budget constraints and subsequently expand their fortunes by engaging in criminal corporate raiding. Netzel refused a court order to testify at Jerzy B.’s trial, a transgression for which he was ultimately fined. Once again, the offshore secrecy

⁹⁵ Preston Smith, “PZU: Where the money went,” *Poland Monthly*, September 2004.

⁹⁶ Ibid.

⁹⁷ Ibid.

jurisdiction of Jersey played a key role in the alleged crimes, with prosecutors claiming that millions of zlotys illicitly ended up there in accounts controlled by Jerzy B.⁹⁸

Friends described Netzel and Jerzy B. as “an inseparable pair” going back to their college days as young members of the communist party and communist students’ league. At one point, Jerzy B. was arrested for illegal black market transactions but was quickly released. “I think he must have started cooperating with the [secret services],” says one of these friends. In 1982, Jerzy B. and some classmates managed to register their company, Bolid A.S., with the authorities despite the fact that marshal law had just been declared. Netzel was allegedly involved in Bolid although his particular role there remains unclear. Bolid benefited from price controls on wood to produce wooden pallets that it subsequently exported to the West in exchange for dollars. It then used these dollars to import textiles and manufacture clothing for sale in Poland. By the late 1980s, Bolid employed several hundred people.

In 1990, the company received a loan worth DM250,000 from Pekao, a state bank. The loan was never repaid, causing Pekao to take Bolid to bankruptcy court with the result that the firm’s assets were seized and its employees left out in the cold. The bankruptcy of Bolid, whose formal owner was a Polish expat in Sweden by the name of Andrzej Stanisławski, caused a scandal in the Swedish press. Many believed that Stanisławski was simply the front-man representing the interests of Jerzy B. Where did the money from the loan end up? A clue emerged after *Rzeczpospolita* revealed information regarding the formation of another company in 1989 just before Bolid’s loan application was approved. The company, Fit, listed three notable names on its Supervisory Board: Jerzy B., Netzel, and Adam Wojtuszkiewicz, the Pekao bank official who would later approve the loan application to Bolid in one of his last decisions before leaving the bank. This suggests that the individuals believed to be behind Bolid had clear links to a Bank Pekao official.

Prosecutors launched a criminal investigation in the early 1990s but soon suspended it, ostensibly on grounds of a lack of evidence. This claim was later exposed as a sham when *Rzeczpospolita* managed - more than a decade later - to easily find evidence of the crime, locating the original approved loan application from Bolid containing the signatures of Wojtuszkiewicz and Jerzy B. When *Rzeczpospolita* first contacted Wojtuszkiewicz about the transaction, he denied that he could ever have approved a loan to a company run by his future business partners. “It would be exceptionally unethical,” he insisted. Upon learning that the newspaper had in its possession the actual loan application with his signature on it, his staunch views on professional ethics underwent a sudden and remarkable shift; he informed the paper that there is actually nothing wrong with a bank official approving such transactions. The fact that the prosecutor protected those suspected of tunneling Bolid’s asset qualifies this as a case of raiding.⁹⁹

⁹⁸ “PZU CEO's Murky Past in Black and White,” *Polish News Bulletin*, 18 August 2006. Unless otherwise noted, the following information on Netzel and Jerzy B. comes from this and the following articles: “Suspicious Past of New PZU Chairman,” *Polish News Bulletin*, 12 June 2006; “Last Week's Controversial CEO Nomination at PZU Triggered Off Media Storm Over Poland's Largest Insurer,” *Polish News Bulletin*, 20 June 2006.

⁹⁹ NPR #5

Another company started by Jerzy B. in which Netzel also served on the board was Marcam Containers, founded at the end of communist rule. Tax officials later discovered that Jerzy B. withdrew PLN600,000 from the company's account. A former accountant confirmed that he "sometimes took as much as PLN200,000." By 1994, Marcam was in serious financial trouble and began laying off employees. Its assets were subsequently seized by a bankruptcy receiver. By 1997, it had liabilities to the Social Insurance Fund (ZUS) totaling PLN5 million. The accountant also described the shady ruse employed to create the fiction that Marcam's initial capital was actually invested in the firm. "For a few years it was not paid in at all," she recalls. "One day Netzel and Jerzy B. brought a million dollars in suitcases, paid it into a company account, and withdrew the whole amount on the next day."

By the time the last employees had left the company in 1997, Netzel and Jerzy B. had already moved onto other pursuits. Among these was a raid on Drob-Kartel, a poultry processor where Jerzy B. was a shareholder and Netzel served on the board.¹⁰⁰ Netzel simultaneously worked at PKO BP, the state bank, where he was later fired for approving loans to Drob-Kartel. According to newspaper reports and former shareholders who lost their entire investments after Drob-Kartel went bankrupt, Jerzy B. was chiefly responsible for its failure by tunneling its assets. In doing so he had the active assistance of Jan Kaczmarek, the bankruptcy receiver.

Kaczmarek also happened to be employed at another Jerzy B. company, Marcam Koegel (separate from Marcam Containers), where Netzel was Chairman of the Supervisory Board. This company, which manufactured trucks and trailers, similarly went bankrupt as a result of a raid.¹⁰¹ Despite his pre-existing relationship with the company, Kaczmarek managed to get himself appointed as its bankruptcy trustee. Court testimony from another bankruptcy receiver revealed that Kaczmarek submitted a false document to the court listing various liabilities that Marcam Koegel allegedly owed to Jerzy B. Ulm, the German truck manufacturer which co-founded Marcam Koegel, eventually realized that the company was being drained of cash through such suspicious transactions. Prosecutors later alleged that Marcam Koegel, like Drob-Kartel, was simply a vehicle for money laundering. This time, Jerzy B. was actually arrested and jailed, but was later released on guarantees offered by SLD politicians in Gdańsk.

Given that PZU has been such a lucrative source of illicit soft budget constraints for members of the Polish elite, it is little wonder that the company has been the object of fierce battles for control. In 1999, a consortium of BIG Bank-Gdański and Eureko, a Dutch firm, won the privatization of a controlling stake in PZU, with BIG Bank-Gdański taking 10 percent and Eureko another 20 percent. Some observers questioned how BIG Bank-Gdański, which was in serious financial trouble at the time, managed to obtain the one billion zlotys to pay for it. They noted that PZU had deposits at BIG Bank-Gdański totaling approximately the same amount. A former Treasury Minister finally came out and said it: BIG Bank-Gdański, he alleged, had used the money it held on PZU's behalf to pay for its own stake in PZU. In any event, Eureko and BIG Bank-Gdański soon fell out with one another. Meanwhile, "a succession of Polish governments chose to renege on the deal, deeming the company a national treasure" and claiming that the privatization

¹⁰⁰ NPR #6

¹⁰¹ NPR #7

had been marred by corruption.¹⁰² Being that most of these allegations were made by the notoriously corrupt SLD government (2001-2005), these claims seemed a bit rich indeed.

The privatization agreement was concluded in 1999 when the government was headed by a right-wing coalition. Once the SLD came to power in 2001, the new Treasury Minister expelled Eureko's representatives from the PZU board in a move later ruled illegal by an international arbitration court. A series of lawsuits followed as well as a multiple investigations by Polish prosecutors into alleged fraud in the 1999 privatization - on Eureko's part only. The conflict ended briefly in 2001 with a deal between Eureko and the Treasury. But then a new SLD Treasury Minister, Wiesław Kaczmarek, was appointed and promptly cancelled the agreement. Kaczmarek's interest in the company's affairs went well beyond his concerns about the integrity of the privatization; he had already appointed allies to senior posts at the company while rumors swirled that his real agenda was to hand managerial control to Kott, the President of BIG Bank-Gdański. More investigations followed, resulting in the arrests of senior PZU officials, including Wieczerzak and Jamroży, for the alleged embezzlement activities described earlier. Wieczerzak and Jamroży were marked men; they had gained the ire of BIG Bank-Gdański in 2000 by allegedly assisting in the attempted hostile takeover of the bank by Deutsche Bank in exchange for secret payments from the latter. Finally, in 2004, a new deal was struck whereby Eureko bought out BIG Bank-Gdański's 10 percent stake in PZU.¹⁰³ Taken together, the repeated attempts by the Treasury to take control of PZU in actions later ruled illegal constituted a criminal corporate raid.¹⁰⁴

Thus far we have seen how soft budget constraints unleashed tides of money from CHZs, debt-service agencies, and financial companies to entrench a new class of political thugs. Another source of soft budget constraints, as in Ukraine and Slovakia, was the energy sector. To begin with, Poland saw the same heating oil scam that enriched so many of Slovakia's political thugs. The scheme involved importing high-tax gasoline and declaring it as lower-tax heating oil so that it could be sold at an artificially high profit. Once again we can observe the usual suspects from the Polish elite at work: former officers from the communist secret services, in this case military counterintelligence. Russian mafia figures based in Brighton Beach, New York were also involved.¹⁰⁵

Prosecutions resulted in several arrests but, naturally, none of the prominent politicians or businesspeople implicated in the scheme were among those targeted. As Witold Gadowski, who made a television documentary about the heating-oil affair, stated, "never has the Polish judicial system reached the level of politicians. It will end at the level of small gangsters."¹⁰⁶ This is despite the fact that one of the participants testified in front of a parliamentary committee that he had seen lists from a Swiss bank showing the names of Polish politicians who profited from the scam. The tax authorities are required by law to inspect fuel refineries to make sure they are honest about what it is they are selling. But a formal request to do so in 2002 was ignored by Wiesław Ciesielski, the ex-nomenklatura SLD official at the Finance Ministry responsible for such

¹⁰² Leonard, "Poles Apart."

¹⁰³ Ibid.

¹⁰⁴ NPR #8

¹⁰⁵ Interview with Witold Gadowski.

¹⁰⁶ Ibid.

inspections. Meanwhile, reports also surfaced of a cover-up by the UOP. As in Slovakia, the fuel trade was marked by violence; at least two individuals, Zdzisław Majka and Stanisław Faltynowski, both connected to the so-called “fuel barons,” were killed between 2000 and 2002.¹⁰⁷

Foreign political thugs, most notably from Russia and Ukraine, have also managed to enter the Polish energy sector. Like in many other Central and East European countries, Gazprom and other entities linked to the Russian state gas monopoly have attempted to force their way into Poland’s gas distribution market. This resulted in a series of highly publicized scandals, particularly under Leszek Miller’s SLD-led government, which ruled from 2001 to 2004. Leftist governments in Poland have been friendlier toward Russia than their right wing counterparts. This, combined with extraordinary corruption that reached new heights under Miller, left the country ripe for invasion by corrupt post-Soviet energy interests.

Upon becoming premier in 2001, Miller announced that Poland did not need all the gas it was importing from Russia and accordingly reduced the state’s purchases from Gazprom. Predictably, a major gap emerged in the supply of Russian gas. Miller then had a “change of heart” and decided that Poland did need all that Russian gas after all - only this time the government would seek to fill the gap by turning to shady gas interests from Ukraine already familiar to us from the discussion in that chapter. At first, Ukrainian business group ISD, owned at the time by Serhiy Taruta, Vitaly Hayduk, and Rinat Akhmetov, seemed poised to become the main supplier of Russian gas to Poland. However, the government instead chose Sinclair, a company linked to former Gazprom chief Rem Vyakhirev. It was not long before Akhmetov managed to get the Polish government to kick out Sinclair in favor of another familiar face from Ukraine, Eural Tranz Gaz (ETG). To recall, ETG was the murky gas intermediary part-owned by Gazprom and part-owned by entities allegedly linked to Ukrainian government officials and international criminal mastermind Simeon Mogilevich. The SLD government signed a contract with ETG for delivery of two billion cubic meters of gas per year. After the shadowy figures behind the scandal-plagued ETG replaced it with a new entity, RosUkrEnergo, the arrangement simply continued with the latter as the new supplier.¹⁰⁸

Another heated scandal surrounded PKN Orlen, the partly state-owned oil refinery and distributor. Since its establishment in 1999, PKN Orlen had a contract with J&S, a Polish conglomerate, that gave the latter exclusive rights to supply the oil refinery with Russian gas. By 2002 that contract was up for renewal, and certain interests around the SLD saw an opportunity to muscle in on the lucrative cash flow from supplying Russian gas to PKN Orlen. On February 6th, 2002, Andrzej Modrzejewski, the CEO of PKN Orlen, discussed plans to renew the contract at a meeting with J&S representatives. The matter was expected to be finalized at a PKN Orlen shareholders meeting two days later, where it would be put to a vote. Unbeknownst to the participants, however, the meeting with J&S had been secretly recorded by state intelligence agents. On February 7th, just one day before the vote was to take place, Modrzejewski was arrested

¹⁰⁷ "Gov't Wants to Offer Bourse Players Shares in Fuel Affair?," *Polish News Bulletin*, May 20, 2005; "Orlen Committee: Though Now Stuck..."; "Orlengate Affair: An Overview," *Polish News Bulletin*, November 17, 2004; "Poland: Mazur investigation said crucial for purging justice system." *BBC Monitoring European*, November 7, 2006.

¹⁰⁸ Interview with Witold Gadowski; Interview with Respondent #70.

and detained, allegedly on orders from Zbigniew Siemiątkowski, the SLD-appointed chief of the Agencja Wywiadu (AW), the foreign intelligence service. The alleged goal was to prevent the contract renewal with J&S from being formally approved and instead give another firm, Petroval, owned by Russia's Yukos, a piece of the action.¹⁰⁹

A parliamentary commission was appointed to investigate the incident. It subsequently blew up into a multitude of related scandals involving alleged bribery, favoritism, and Russian spying in the Polish energy sector. For instance, evidence emerged that Jan Kulczyk, a PKN shareholder and one of Poland's plutocrats, used his political influence to reopen the privatization of the Gdańsk Oil Refinery. Acting on behalf of a former Russian spy, Kulczyk allegedly offered to lobby President Kwaśniewski and bribe Treasury Minister Kaczmarek to make sure the refinery would be awarded to Russian oil major Lukoil.¹¹⁰ The inquiry also revealed a massive scheme to funnel bribes from businesspeople to President Kwaśniewski through a sham "foundation" run by the President's wife.¹¹¹ It also opened a window on intrigues by the UOP to place its representatives in high-level posts at PKN Orlen.¹¹²

As the preceding discussion has made clear, former officers and agents of the communist intelligence services were among the most prominent beneficiaries of soft budget constraints. Many of them have also found lucrative jobs providing intelligence to Western firms investing in Poland. This is not unusual in itself; even in the West, companies frequently hire former intelligence and special-operations personnel to protect industrial secrets, for instance. In Poland, however, their main value lies in their access to critical intelligence in a country where basic information - information that might be openly available in the advanced-industrialized democracies - can be very hard to come by. But they are also used to "screen potential partners, or even enforce claims and sometimes act on behalf of the judiciary," says professor Krzysztof Jasiński of the Polish Academy of Sciences. "For foreign companies, the former operatives are an invaluable source of information: what is the local arrangement, whom it is worth doing business with, how to approach someone to do business. They also have operative knowledge on people's weaknesses: who can be pressed, who blackmailed, and who simply waits for a payola."¹¹³

One of the most prominent ex-spies involved in this business is General Gromosław Czempiński, the former chief of the UOP. He left his post in 1996 and went on to work for 23 companies in sectors ranging from telecoms and energy to transport and finance. He has been employed by a number of Poland's most prominent businesspeople such as Jan Kulczyk and Sobiesław Zasada. Czempiński also owns

¹⁰⁹ "Mountain Giving Forth a Mouse Is There Any 'Orlen Scandal' At All?," "Ivan at the Pipe, 2004; "Orlengate Affair: An Overview" 2004.

¹¹⁰ "Mountain Giving Forth a Mouse: Is There Any 'Orlen Scandal' At All?" *Polish News Bulletin*, January 13, 2005; "Ivan at the Pipe," *The Economist*, December 11, 2004; Stefan Wagstyl, "Polish Businessman Warns of 'Damaging' Political Attacks." *Financial Times*, November 9, 2004; 2004; "Orlengate Affair: An Overview."

¹¹¹ "Orlen Committee: Though Now Stuck..."; "How Being a Politician's Kin May Help Your Business Career." *Polish News Bulletin*, August 23, 2004; "Shareholders of Polish Oil Trade Intermediary Deny Special Services Links." *BBC Monitoring International Reports*, March 31, 2005.

¹¹² "Orlen Committee Though Now Stuck..."

¹¹³ "Spies for Hire: Use of Former Ops Destroys a Level Playing Field in Business." *Polish News Bulletin*, August 12, 2004.

several companies and serves on the supervisory boards of many others. He was an advisor during the 2000 sale of Telekomunikacja Polska (TP SA), the fixed-line telephone network provider, to France Telecom and Kulczyk Holding. Wojciech Brochwicz, a previous Deputy Interior Minister and chief of the UOP, was an advisor to Ukraine's ISD when it was attempting to acquire the Huta Częstochowa steel mill. In 2004, Krauze's Prokom hired Mieczysław Tarnowski, the previous deputy head of the Internal Security Agency (ABW), created after the UOP was disbanded in 2002.¹¹⁴

What has really pushed these former intelligence officers into private business has been the semi-continuous purges of the intelligence agencies. Mass dismissals affected half of the communist-era secret services and were extended to another 1400 UOP officers under Prime Minister Buzek of the AWS. More followed under the SLD, especially after the government split up the UOP into the ABW and AW in 2002. "We're talking about 10-15,000 people" in all, notes Jasiński.¹¹⁵

The UOP and its successor agencies have played an important and very unofficial role in post-communist Polish politics. According to Łoś & Zybertowicz, the agency makes liberal use of its access to the SB's secret files. The files have enabled it to blackmail scores of prominent figures in the political and business spheres under threat of exposing their former collaboration with the SB. The UOP also continued to employ thousands of secret agents to infiltrate myriad institutions, organizations, and companies, both public and private. In 1992 it issued a secret directive, signed by the agency's director, which ordered the penetration and disruption of independent political groups. Another secret order, leaked in 1996, authorized the collection of intelligence in workplaces and trade unions. Even more alarming was its alleged role in engineering the downfall of two Prime Ministers, Waldemar Pawlak and Józef Oleksy, through the selective publication of compromising materials concerning them. Another Prime Minister, Jan Olszewski, was ousted in a scandal that erupted after his Interior Minister used secret archives to amass dirt on sitting parliamentary deputies regarding their previous collaboration with the SB.¹¹⁶

Socialist-Engineered Raids, 1993-2004

The dense networks linking ex-communist spies and other officials from the old regime make these individuals prime candidates to become political thugs. And because criminal corporate raids require political protection in one form or another, it is hardly surprising that most of the raids I found took place under governments ruled by the main communist successor parties. The first of these, led by the SdRP, was in power from 1993 to 1997 and the second, under the SLD, governed from 2001 to 2004. The following discussion details some of these raids. The reader should nevertheless keep in mind the high likelihood that the raids presented here barely scratch the surface of what lurks beneath in the seedy underworld of Polish capitalism; the ease with which I was able to identify such takeovers left me with the strong impression that the ones I did not find far exceed the ones I did. Table 6.6 contains a list of all non-plutocratic raids I

¹¹⁴ Ibid.

¹¹⁵ Ibid.

¹¹⁶ Łoś and Zybertowicz, 180-83.

Table 6.6. Alleged Non-Plutocratic Raids: Confirmation Indicators

Indicator Key	
<u>Indicator #</u>	<u>Description</u>
1	Many domains
2	Spontaneous public actions
3	Unrelated offenses
4	Non-existent laws
5	Suspicious bankruptcy / redistribution
6	Repeated investigations/prosecutions
7	State action in midst of political conflict
8	Direct force
9	Threats made
10	State actions ruled (or suspected to be) illegal
11	Target is a rival of powerful interests
12	#2, 8, or 9 coincides with state action
13	Illegal board meeting

<u>Raid #</u>	<u>Target</u>	<u>Indicators</u>													<u>Substantiated?</u>
		1	2	3	4	5	6	7	8	9	10	11	12	13	
1	BIG Bank-Gdański													X	Yes
2	Lublin Brewery	X													Yes
3	JTT Computers					X				X					Yes
4	CLiF					X				X					Yes
5	Bolid									X					Yes
6	Drob-Kartel					X									Yes
7	Marcam Koegel					X				X					Yes
8	PZU		X	X			X			X	X	X	X		Yes
9	Gerard Knosowski					X				X					Yes
10	Conti					X				X					Yes
11	PHU Nina	X								X					Yes
12	Port									X					Yes
13	Beat									X					Yes
14	Arcadium	X		X						X					Yes
15	SSPH	X				X				X					Yes
16	Krup-Stal								X						Yes
17	Farm Agro Planta								X	X					Yes
18	Radio Blue									X					Yes
19	Twoje Radio														No
20	Atrax									X					Yes
21	Griffin									X					Yes
22	BPH/Unicredito									X					Yes
23	Pozmeat					X				X					Yes

found, broken down in terms of the presence of the various raiding indicators in each case.

Starting out with a small workshop, Gerard Knosowski managed to build a thriving company in Wrząca specializing in home construction. As many successful businesses often do in Poland, Knosowski's enterprise became the target of a criminal corporate raid. Jerzy Teichmann, a businessman whose wife was a Polish ambassador and member of the social-democrats, was the beneficiary of an alleged attack on Knosowski and his business in the mid-1990s.¹¹⁷ It consisted of a series of actions evidently coordinated among prosecutors, courts, banks, and bankruptcy receivers. Banks that had lent money to Knosowski's company suddenly called in their loans while Knosowski was jailed for 13 months on trumped-up embezzlement charges. His business collapsed. A court later exonerated him and ruled that the state officials involved unlawfully orchestrated the bankruptcy of his firm. Nevertheless, that decision only came in 2006. This was a full decade after Teichmann bought the bankrupt company for PLN716,000 and sold it two years later for over 20 times the price he paid - apparently without making much improvements to it during the interim. Knosowski received PLN24,000 in compensation, far less than the PLN32 million he claims to have lost.¹¹⁸

Conti, a foreign exchange dealer, became the target of another illegal takeover attempt in 1995.¹¹⁹ Its owner, Paweł Zaleski, was wrongfully arrested and jailed by Gdańsk authorities for money laundering and tax fraud. During part of his time in pre-trial detention, he was unlawfully transferred to a maximum-security prison outside of Gdańsk. This was a violation of the law, which requires prisoners in Gdańsk to serve their time inside the city. He was eventually acquitted in 2001, but during the interim the authorities confiscated PLN2 million from Conti in distraint proceedings, forcing it into bankruptcy. When property is seized in distraint, usually in lieu of repayment of a debt, it is supposed to be given back once the matter is settled. In Conti's case, only PLN1.2 million of the PLN2 million was returned; the other 800,000 was stolen by an employee of the court. The court employee was later sentenced for this crime but never gave the money back. Responsibility for that now lay in the hands of the Gdańsk district court, which was required by order of a superior court to pay the missing money to Zaleski and Conti's liquidator. Nevertheless, it consistently refused to comply with this order. As of 2013, the money still had not been returned.¹²⁰

In 1997, a tax office inspector visited Eltor-Pol, a construction company in Zielona Góra, and accused it of misstating a small part of its revenue.¹²¹ However, the fine the local tax office imposed for this alleged transgression was wildly excessive; it was calculated as if the accounting mistake affected the company's entire turnover as

¹¹⁷ NPR #9

¹¹⁸ "Od milionera do biedaka," *Gazeta Poznańska*, 1 October 2003

(<http://wiadomosci.wp.pl/kat,12351,title,Od-milionera-do-biedaka,wid,1547992,wiadomosc.html?ticaid=1133e0>); "Charitable tax," *Polish News Bulletin*, 8 February 2006; Interview with source.

¹¹⁹ NPR #10

¹²⁰ Wojciech Wybranowski, "Temida trzyma cudze jak własne," *Rzeczpospolita*, 15 October 2012 (<http://www.rp.pl/artykul/945762.html>); Grzegorz Szaro, "Prokuratura traci pamięć," *Gazeta Wyborcza*, 26 October 2007.

¹²¹ Because the authorities' actions did not affect all or substantially all of Eltor-Pol's assets, this case does not qualify as a raid.

opposed to the modest portion it actually did. Instead of reviewing whether it had made a mistake, the tax office allegedly issued threats to Eltor-Pol's owners and informed its banks of the overstated tax arrears, causing the banks to freeze the company's accounts. As a result, Eltor-Pol had to sell off substantial parts of its assets and dismiss 88 of its 100 employees.¹²²

Another raiding victim was Nina Cholewicka, owner of PHU Nina, a successful clothing manufacturer in the town of Chmielnik.¹²³ In 1996, she received simultaneous visits from the Tax Inspection Office, the special police unit for combating economic crime, and the environmental protection agency. The tax authorities continued to persecute her for the next three years on the basis of tax fraud allegations. Their endless inspections prevented the normal operation of her business. Other regulators in the region faced pressure to cooperate in the attack. Cholewicka still recalls how the local customs office refused to provide her with clearance on goods she had imported: "I am standing with the goods, waiting for someone to put the duty stamp on it. The customs officers are milling about; no one approaches me. Finally, one of them whispers: 'Putting you through customs clearance is worse than if you had drugs. We have all been interrogated to find out the quantity of goods you have been importing'."¹²⁴

The constant harassment along with the requirement to pay the disputed back-taxes before the appeals process was complete ended up forcing PHU Nina into bankruptcy. Cholewicka and her family lost everything. Fortunately, a law firm took up her case on a *pro bono* basis and initiated an ultimately successful court battle against the regional authorities. In 2006, the District Court of Kielce acquitted her on the tax fraud charges. The ruling was affirmed by the Supreme Administrative Court in 2008. "This case practically ruined her professional and personal life," her lawyer said. "Finally, justice has been done. Now Nina has an open route to claim compensation for the losses she has suffered."¹²⁵

Around the same time PHU Nina was collapsing, a remarkably similar series of developments led to the bankruptcy of Jerzy Kulas' wholesaler, Port.¹²⁶ A 1997 audit by the Treasury Office in Elbląg concluded that Port had underpaid on its VAT obligations. The law allowed such decisions to be enforced before the appeals process had run its course, and the Treasury Office did just that, thereby forcing Port into bankruptcy. In 1999, the Supreme Administrative Court accepted his appeal and ordered the Elbląg Tax Chamber to review the previous decision by the Treasury Office. The review concluded that, far from underpaying on its tax obligations, Port had *overpaid* by PLN26,000. Kulas eventually received part of the overpayment back from the state, but by that point his business had long ago failed. "The Treasury lost nearly 15,000 zlotys (3k GBP) for paying me the interest and I lost all my assets, good health and job," he complained.¹²⁷

¹²² Leszek Kostrzewski, "Spółka żąda 11 mln odszkodowania od fiskusa," *Gazeta.pl*, 30 June 2004 (<http://gospodarka.gazeta.pl/gospodarka/2029020,52981,2157649.html>).

¹²³ NPR #11

¹²⁴ Ziemowit Nowak, "Skarbowe eksperymenty na ludziach," *Gazeta Wyborcza*, 16 April 2009; Ziemowit Nowak, "Nina nie musi płacić. Teraz zapłaci fiskus?" *Gazeta Wyborcza*, 15 March 2009

¹²⁵ Ibid.

¹²⁶ NPR #12

¹²⁷ Iwona Trusewicz, "Miał firmę, teraz ma tylko rację," *Rzeczpospolita*, 19 January 2004 (<http://archiwum.rp.pl/artykul/469418-Mial-firme-teraz-ma-tylko-racje.html>).

Kulas decided to sue the Treasury Office for a half-million zlotys in damages. In January 2002, he went to the local Treasury branch to present his claim and returned home afterward. Then “a strange thing happened. A few hours later the police knocked on my door. Without a warrant from the prosecutor, they handcuffed me in front of my neighbors and put me in a car. I landed in police custody, where I heard that I had threatened to kill a tax office employee,” he said. The employee who initially made the accusation withdrew her claim during the court hearing that followed. The case was accordingly dismissed in November 2002.¹²⁸ Whether or not the attack on Port amounted to an attempt to take it over, the incident does qualify as a raid; regardless of what their ultimate objectives were the tax authorities were perfectly willing to destroy Kulas’ business to achieve them.

The attempted destruction of successful businesses on the basis of false back-tax claims has indeed become something of a pastime for Poland’s regional authorities. Beat, a cosmetics wholesaler, was another victim of the standard treatment.¹²⁹ Although it occurred during the right-wing Buzek government (1997-2001), the province where the business was based was under SLD control at the time. In 2000, the Treasurer’s Office in Kielce - the same one that bankrupted PHU Nina - accused Beat’s owner, Beata Z., of using a series of 18 fictitious businesses to claim fraudulent VAT refunds. In response, Beata Z. launched her own private investigation and discovered that the tax officials had simply concocted the evidence out of thin air. Nevertheless, her appeal to the Supreme Administrative Court was rejected. After this, the Ombudsman got involved on Beata Z.’s behalf and eventually helped her obtain a favorable ruling from the Appellate Prosecutor’s Office in Kraków, which ordered the Kielce Prosecutor’s Office to reevaluate the case. The Kielce Prosecutor refused, however. I was unable to verify how the affair was eventually resolved but, fortunately for Beat, it managed to survive the ordeal.¹³⁰

Criminal corporate raiding would reach new heights under the premiership of Leszek Miller in the SLD government that ruled from 2001-2004. These raids were largely the work of political thugs who had already grown rich from soft budget constraints. They affected companies large and small both in Warsaw and in the provinces, where power was held by regional “barons” tied to the SLD.¹³¹

One of these SLD barons was behind a criminal corporate raid on two of my respondents, whom I will refer to as Jacek and Ewa.¹³² They own a successful business (“Arcadium”) that employs around 100 people. The raid on Arcadium reveals important and detailed insights into the anatomy of such takeover attempts.

Jacek and Ewa privatized Arcadium in the 1990s. The reason they came under attack, according to Jacek, was because the SLD boss in the region - a former communist official, of course - had had other plans for Arcadium before the couple managed to buy it. In particular, he had intended to arrange the company’s privatization to his cronies so that they could strip it of assets.

¹²⁸ Ibid.

¹²⁹ NPR #13

¹³⁰ Ziemowit Nowak, “Beata, trzymaj się!” *Gazeta Wyborcza*, 25 March 2004.

¹³¹ Grzymała-Busse, 69.

¹³² NPR #14. The following information comes mostly from interviews conducted with Jacek and Ewa in 2008. A small amount comes from email correspondence over the ensuing years.

As retribution, the SLD boss launched an attack on Arcadium along with Jacek and Ewa themselves. The raid involved coordinated action by multiple state agencies, not only at the regional (*województwo*) level but also the district (*powiat*) and parish (*gmina*) levels. (The structure of the Polish state extends from the national to the regional level and then down to the district level and ending with the parish, the smallest unit.) According to Jacek, Polish law grants broad discretion to regulators to determine whether business owners are acting against the interests of their companies. Moreover, the SLD passed a law giving prosecutors wide scope to pursue business owners in such cases. If a crime is suspected, says Jacek, the police can recommend that the prosecutor shut down the company and place the owner in pretrial detention. Meanwhile, regional and local party authorities can arrange for the appointments of cronies to key law-enforcement positions and also sway judges to collude with them. “So really they have the power to go to your enterprise and do anything to you that they want,” says Jacek.

The district and regional tax offices play instrumental roles in such raids. Polish companies are required to pay certain taxes on regular intervals regardless of whether customers are paying their invoices in a timely manner. These include VAT and withholding taxes on employees’ income. If clients are aware that the company is under attack, says Jacek, they will hold back on their bill payments in expectation that the targeted firm will soon be bankrupt. But if the company fails to pay because of a shortage of cash, the tax office has a number of remedies at its disposal. Depending on the circumstances, the measures can range from suing the firm to the detention and criminal prosecution of its managers. Delinquent payments can also result in additional monetary charges, typically amounting to 15 percent of the tax liability. Of course, “the local tax office doesn’t have to be so strict, but all the heads of the local and regional tax offices are directed by the political barons.”

Another role the regional tax office plays is to provide key information to raiders as they choose which business to target. This office “knows everything about you,” Jacek notes, “. . . who you sell to, what you buy, what the prices are, what the payments are.” It can initiate audits of firms, sending in agents to collect information that might later be used against the firm or its owners. The law requires that auditors seeking to collect such information present a document specifying exactly what information is sought. In one instance, however, an auditor visited Arcadium with a form that was completely blank yet already contained the signature of the tax office head. This gave her unlimited authority to vacuum up as many documents and files as she could.

The tax audit, Jacek says, “is the best source of business intelligence for your competitors. . . . So if this mafia sees a nice business, and they know he does not have a political umbrella strong enough to fight them, then this man is lost. He doesn’t know it, but he is lost.” Banks, whose heads are connected to the regional political boss, begin calling in their loans and the company’s fate is sealed:

The thing is, if you are facing prosecution, the people you sell to decide that “something’s wrong with this guy, let’s try not to pay him what we owe. He’s going to collapse!” And the black PR is circling around you. You understand what I mean? For example, to take a bigger contract you need to have a kind of a bank guarantee. . . . But no bank will give you the guarantee, so you can’t sign any contracts. So they circle around the factory and they play with this businessman,

play with his mind, and they wait for the best moment to finish him off. And so all the people around take what they want. Even the best business can go down in half a year. No money from the bank, no management present. Everybody thinks that maybe something is really going on there, maybe he really is a naughty boy.

With bankers and customers bailing out en masse, the business can face imminent bankruptcy, which, according to Jacek, is precisely the goal of the raiders:

The idea works like this. This judge has links to the [bankruptcy] receiver, and the receiver is working with the court. Everything is done according to the law. But the link between the judge and the receiver exists beneath the law. Let's say there are ten bankruptcies, but only one of them is interesting, you know. It's a valuable business, and we already know there is a big boss who wants control over it. And so we give this bankruptcy to my receiver, and the receiver manages the bankruptcy process like this so that these assets that the political boss covets are sold to his people at cheap prices. This process of bankruptcy is directed by the boss, the big local politician, and the people who surround this big politician. And I would say a high percentage of these people are straight from the communist party or the secret police during communist times because they have the links with the banks and politicians. So this is the main player – the former secret police.

Jacek describes the suffocating effect the constant inspections and audits had on his business as well as Ewa and himself. During one three-month audit, he had four employees working full time just to tend to the inspectors. "According to the law, you have to give them their own room, a copy machine, coffee, everything they need. So you spend all of your time between 9 am and 3 pm tending to the inspectors, and then you can run your business after that. You have no time to sleep, to eat, to think, for your family. You are like a ping pong ball being hit back and forth. I lived like this for six years." And the whole point of such information-gathering efforts, he claims, was to dig up incriminating information that could be used against him. "You prepare everything, and they sit there and write everything down so that they can figure out how to find some pretext to squeeze you."

The attack on Arcadium and its owners illustrates a common feature of criminal corporate raids: the coordinated action of multiple state agencies to harass and disrupt the takeover target. In Poland, the state bodies that become involved range from the police, intelligence agencies, prosecutors, and judges to the regional branch of the Supreme Audit Chamber (NIK), and the company's banks along with the regional, district, and parish tax offices. The broad personal authority of the regional party boss is what allows such coordination to take place to begin with. In Arcadium's case, "the whole thing was arranged by the provincial authorities because, at the time, the SLD was in power in this province, and there was an SLD baron, just like in feudal times, who managed everything and everybody – in the tax office, in the prosecutor's office, and also the Supreme Audit Office branch in the regional capital." In addition to the constant inspections at Arcadium, both Jacek and Ewa were prosecuted for various crimes ranging from corporate malfeasance to forgery.

Coordination and information-sharing among the different state agencies gave the raiders critical intelligence on Arcadium. They thus remained aware of its situation at all times and could choose the right moment, when Jacek and Ewa were most vulnerable, to step up their attack. In one instance, the local tax office sent the bailiff to make a big public display of seizing the company's property just after Jacek had left on a trip to Warsaw, a trip they obviously knew about in advance. The intention, he thinks, was to undermine Arcadium when Ewa was there alone to fend for herself, creating the impression that Arcadium was bankrupt and leaderless to boot. This way, the banks, customers, and suppliers would act accordingly and start abandoning the firm.

To take another example, the parish tax office handed down five highly unfavorable decisions right before Jacek was about to leave for Italy on a business trip. The decisions would later be overturned, but not without causing serious interruptions to Arcadium in the process. While the prosecution against the couple was moving forward, Jacek's business had successfully applied for funds from PHARE, an EU agency that helps businesses finance investments. PHARE would only provide the financing in conjunction with additional financing arranged by Arcadium. Jacek and Ewa duly obtained agreement from the bank to loan them the required funds.

However, just as the PHARE award was announced, the raiders stepped up their attack. First, the regional branch of the Supreme Audit Office (NIK) publicly leaked allegations that Jacek had stolen money from Arcadium. Jacek had already sent a lengthy reply to the very same allegations when they were first made two years earlier. After he submitted his response, he heard nothing - until the allegations were suddenly leaked to the press a year-and-a-half later. Meanwhile, the judge presiding over Jacek and Ewa's trial suddenly demanded that they put up PLN200,000 in bail - in cash only. Otherwise, they were told, they would be arrested. The sudden demand for cash threw the whole investment along with the PHARE funds into jeopardy. If the authorities really had evidence of fraud, they could have sent the information to the prosecutor - and done so without waiting years after first learning about the "crime." Instead, they chose to sit on the information until the couple was most vulnerable.

Before the trial had even ended, the district police, perhaps sensing that the prosecutor might not be able to obtain a guilty verdict after all, issued a warrant for Jacek and Ewa's arrest. Had they actually been arrested, Jacek claims, their business would have gone bankrupt, which of course was the whole idea; a bankruptcy would have allowed the raiders to take control of the firm on the cheap. They were saved only after the intervention of a member of parliament. However, the authorities' legal pursuits against the couple continued for years afterward. Many local journalists and politicians had been hoodwinked by the raiders' propaganda campaign into believing that Jacek and Ewa were criminals. Finally, in 2011 the prosecutor recommended that they be acquitted of all charges. The judge agreed, declaring them innocent. It was a victory for Jacek and Ewa, albeit one that came at tremendous cost in terms of time, money, and stress. "Not one police officer or the prosecutor had to present any explanation as to why they had initiated the legal proceedings against us in the first place."

The ordeal of Jacek and Ewa underscores one of the main conclusions of this study: once a critical mass of political thugs and crony capitalists forms in the business and political spheres, they create an environment that systematically selects against entrepreneurs, who often find themselves marginalized and threatened. "If all these

people – the prosecutors, policemen – know that this businessman is OK, then nobody attacks you. It doesn't even need to be said; they just sense which way the wind blows. But if you are from the outside, lack a political umbrella, or support an opposition party, then you become the target - or if you just happen to be a young man with innovative ideas who believes that we live in a free country and opens a business. So they see you and take notice of all your steps. And if they initiate an investigation, they listen to your phone calls. So one man is left to fight against the whole governmental structure.”

Jacek portrays a system where regional bosses have broad and arbitrary power to privilege certain business actors and marginalize others. Referring to the head of the local tax office, Jacek notes that “There are many decisions that rest in his hands. He can give you a longer time to make a payment or else grant you a deduction. So he does as he wants...But if the firm is on the right side and the local tax office is from the same side, all the interests are aligned and the firm has got a beautiful life.”

Indeed, local politicians and officials collude to make life impossible for firms like his that do not belong to the communist old-boys network. For instance, decisions on what kinds of activities are and are not permitted on certain lands are governed by zoning laws. But where no zoning plan has yet been adopted, even the most minute decisions - say, where to place a wall on a new building - must get prior official approval. And so local officials who are primarily interested in extorting bribes from businesses tend to make sure that such delays in the adoption of formal zoning plans become permanent. In one case, a local official spelled out 117 separate rules governing precisely what Arcadium could do with its land. Of course, the rules made little sense, prompting him to appeal to the local council - which, of course, was dominated by deputies linked to the regional SLD network. He submitted extensive documentation showing precisely how the 117 rules were at odds with common business sense, but to little avail. “We went to explain all the problems to the local council but they had already agreed among themselves that they were going to squeeze us. I mean, it was clear that three-quarters of them didn't even read this rubbish. You understand what I mean? They were from the party, and the party had told them ‘go after this guy’.”

Yet political thugs and crony capitalists - who of course have the proper political connections - get away with VAT fraud and other schemes. This gives them a further edge over entrepreneurs, who lack the necessary political links to do the same. Just as they can game the VAT system, firms that are connected to the local party network can avoid making ZUS contributions as well. Meanwhile, the Regional Institute of Financing (RIF), the provincial body in charge of disbursing European Union funds to businesses, tends to be captured by local party interests who use it to benefit their own clients at the expense of others, like Jacek and Ewa. The RIFs are especially important outside of Warsaw where local businesses often depend on them to finance upwards of 30 to 50 percent of an investment. “And, of course, they cannot distribute funds to a guy who's being prosecuted,” Jacek adds. The same is true for the Agency for Development and Modernization (*Agencja Rozwoju i Modernizacji*) which distributes EU agricultural subsidies.

The harrowing experience of Jacek and Ewa is not necessarily typical of all entrepreneurs in Poland. But it does go to show how, for enterprising businesspeople who simply seek to build their firms and keep their heads down, life in the Polish provinces can be bleak and isolated indeed.

Other Raids under the SLD

The rise of the SLD government in 2001 ushered in a series of arrests of prominent business leaders on trumped-up charges. We have already covered the arrest and detention of Andrzej Modrzejewski, chief executive of PKN Orlen, in 2002. But there were scores of others as well. One of these victims was Jacek Turczyński, who had been appointed by the previous government as General Director of Poczta Polska, the state postal service. His arrest came in February 2002 on charges of accepting a bribe. The only evidence supporting this allegation was the slanderous testimony of an individual who later recanted the claim. According to Turczyński, he was held for months under maximum-security conditions and deprived of his right to examine the evidence against him. During this time, his wife was tailed by a surveillance team and even suffered a physical attack. Turczyński was released later that year after posting PLN40,000 in bail. No indictment was ever brought against him.¹³³

Poczta Polska was 100-percent owned by the state, so this incident does not actually count as a raid. But it was indeed part of a broader attempt by the SLD coalition to eliminate persons of questionable loyalty from control of key companies, both public and private, and transfer control to its own cronies instead.

Another victim of the SLD round-ups was Krzysztof Piotrowski, former Chairman and President of Stocznia Szczecińska Porta Holding (SSPH), along with four other board members.¹³⁴ Porta Holding privatized the Stocznia Szczecińska shipyard in 1993 and subsequently founded SSPH. SSPH became a successful shipping operation but had run into financial trouble by 2001. Piotrowski maintains that it only needed a bridge loan, but the banks refused to step in to provide the necessary financing. Then, in December 2001, the local government in Poznań decided to jack up the rates on land leased to SSPH by a factor of 26. This added to the company's woes just in time for the Treasury Ministry to demand that new shareholders be brought in on highly unfavorable terms to the existing owners. The board refused this demand. By sheer coincidence, on that very day prosecutors in Poznań suddenly discovered that embezzlement was afoot at SSPH. Police arrested the recalcitrant board members along with Piotrowski. The methods used seemed designed to attract the maximum possible media publicity. The SSPH officials were detained in restaurants, cars, and other public places (this despite the fact that at least one of them had already signed a statement pledging full cooperation with investigators).¹³⁵

A week later, the board resigned. A new President was appointed by the Treasury but remained in office only four days. Those four days turned out to be critical, as

¹³³ Michał Matys & Ewa Milewicz, "Jak się łapie biznesmena," *Gazeta Wyborcza*, 11 March 2003 (<http://wyborcza.pl/1,75248,1367740.html>).

¹³⁴ NPR #15

¹³⁵ "Janusz Kaczmarek utrudniał śledztwo w sprawie afery Stella Maris," *Bankier.pl*, 9 September 2007 (<http://www.bankier.pl/wiadomosc/Janusz-Kaczmarek-utrudnial-sledztwo-w-sprawie-afery-Stella-Maris-1634744.html>); "Bankruptcy of Szczecin Shipyard Meant Profits for Others." *Polish News Bulletin*, April 15, 2003; "Beata Pasek, "Shipyard bankruptcy tests Poland's commitment to post-communist restructuring." *Associated Press Newswires*, August 13; "Szczecin Bosses Brought to Account." *Polish News Bulletin*, July 11, 2002; "When the Boat Doesn't Come In." *Polish News Bulletin*, December 13, 2001; "Bankrupt Porta Holding managers found not guilty," *Pulz Biznesu*, 3 April 2008.

SSPH's most valuable holding, Porta Petrol, was sold to another firm, Prolim. Prolim's main shareholder was a prominent SLD activist named Jerzy Jędrykiewicz, another former SLD "baron" in Pomerania (who was arrested in 2013 on unrelated money-laundering charges). In June, a court declared SSPH bankrupt. Its remaining assets were sold while most of its employees were laid off. Piotrowski maintains that the SLD government intended to ensure SSPH's bankruptcy precisely so that it could transfer the valuable petrol assets to Jędrykiewicz. Of course, all SSPH officials who faced charges were later acquitted. But, as is usually the case in such takeovers, by that time the raiders had achieved their objective in seizing the company's assets.¹³⁶

In another case, a "network of bandits, police, lawmakers, officials, and politicians" – from the SLD, of course – tried to take control of Krup-Stal. A steel-trading company in the province of Płock, Krup-Stal was owned by Krzysztof Olewnik. Olewnik had received an "offer he couldn't refuse" from local SLD politicians who sought to use the firm to smuggle imported alloys into the country without paying taxes or duties. The "offer" involved handing over part-ownership and ultimate control of Krup-Stal in return for avoiding punitive actions that could lead to its bankruptcy. Krzysztof did refuse the offer. Shortly afterward, he was kidnapped and eventually killed by his captors. "Taking into consideration how the kidnapping went and how long it lasted, it's hard to believe that it was only about the 300,000 euro ransom," said a lawyer representing the family. Lending credence to this view were events that occurred following Krzysztof's abduction. "After the kidnapping, various institutions started to harass us with audits," complains Krzysztof's sister, Danuta. "They checked our credit, examined our business activities. It was absurd, because the state was fighting us and we were doing the state's job. We were carrying out the investigation on the prosecutor and the police."¹³⁷

An official investigation ensued but was badly botched. According to one journalist, it "seemed aimed more at covering the tracks of the kidnapers than finding the culprits." Until he was killed – a full two years after the kidnapping – the police continued to peddle the unlikely theory that Krzysztof, an established and successful business owner, had simply run away. Reports were falsified, investigations stifled, and obvious clues that could have saved Krzysztof's life ignored. After his murder, the two kidnapers were arrested. But they mysteriously hanged themselves in their prison cells before they had a chance to lead investigators to any higher-ups in the operation. ("Suicides" tend to be a common method of eliminating evidence in Poland, as witnessed in the cases of Tadeusz Maziuk, the main suspect in the assassination of Jerzy Buzek's Minister of Sports, and Jeremiasz Barański, the Pruszków organized crime leader who supposedly hired Maziuk.) Seeking justice for their son, the Olewniks "came up against a wall of indifference, unwillingness, and discouragement from officials, officers, and politicians." Among these were successive Justice Ministers, a state prosecutor, and Ryszard Kalisz, the Minister of Internal Affairs, who "treated us like dirt," according to Danuta Olewnik ("Well, cars go missing in Warsaw" was his response to her query as to how a police car containing official reports on the investigation ended up stolen). Krzysztof's father, Włodzimierz Olewnik, does not mince words in assigning guilt for his

¹³⁶ Ibid.

¹³⁷ NPR #16. Rafał Pasztelański, "Kto zabija państwo," *Wprost*, No. 16/2008 (<http://www.wprost.pl/ar/127632/Kto-zabija-panstwo/>).

son's murder: "Left-wing politicians have my son's blood on their hands!" he exclaimed.¹³⁸

Another SLD raid resulted in the expropriation of Mirosław Ciełuszecki, owner of Farm Agro Planta, one of the biggest importers of fertilizers and raw materials in Poland.¹³⁹ After the SLD came to power in 2001, Ciełuszecki was arrested and spent eight months in jail. He subsequently lost his Białystok-based company along with a substantial amount of his personal assets. He was tried and sentenced to four-and-a-half years in jail. Later, the sentence was overturned and a retrial ordered on the grounds that the evidence used to convict him was insufficient. As of this writing there seems to be no end in sight for Ciełuszecki. Prior to its downfall, Farm Agro Planta was planning to purchase some of the largest chemical plants in the country. It was also making arrangements for a public listing on the Warsaw Stock Exchange. During a subsequent investigation into the affair, Marek Karp, founder of the Center for Eastern Studies and a former advisor to Ciełuszecki, was killed while on his way to give testimony. His car was "accidentally" struck by an oncoming lorry. Suspicions as to who was behind the raid on Farm Agro Planta have fallen on a Russian oligarch with interests in the chemicals and fertilizer industry.¹⁴⁰

Radio Blue, a popular radio station in Kraków, also found itself on the receiving end of an SLD-backed raid.¹⁴¹ In 2002, the National Radio and TV Council (KRRiT) suddenly cancelled the station's license and granted it to a competing station, ESKA. ESKA's owner was an SLD-connected businessman, Zbigniew Benbenek, who gained particular notoriety for the impressive influence he wielded over the ruling coalition. At the same time that KRRiT made its decision to not renew Radio Blue's license, it also revoked the license of another station, Twoje Radio.¹⁴² The decisions were ostensibly based on alleged irregularities regulators had discovered in the two stations' financing arrangements.

Both moves drew the vehement condemnation of Reporters Without Borders, which alleged that the Polish government was unduly intervening in the Polish media. It also attracted protests from the United Nations Human Rights Commission, the mayor of Kraków, and scores of actors, musicians, and radio listeners. "We are astonished that this decision has been made without warning, without any reason given and without any chance of an appeal," the Secretary-General of Reporters Without Borders complained in a letter to Juliusz Braun, the head of the KRRiT. Meanwhile, the cancellation of Twoje Radio's license spurred popular demonstrations in Wałbrzych, the mining town where it

¹³⁸ Ibid. "Kulczyk's Counsel in Bad Light, Linked to Mafia Leader" *Polish News Bulletin*, December 2, 2004.

¹³⁹ NPR #17.

¹⁴⁰ Przemysław Harczuk, "Rosyjski oligarcha miał związek z dramatem na Podlasiu?" *Pogotowie Dziennikarskie*, 4 March 2014 (<http://www.pogotowiedziennikarskie.pl/niezalezna-informacja-lokalna/artykuly/rosyjski-oligarcha-mial-zwiazek-z-dramatem-na-podlasiu>); "Polish FAP Receiver Offers Assets for 1.7 Mln Euro" *Polish News Digest*, 16 March 2004; "Stracił firmę i prywatny majątek," *Latkowski.com*, 20 Oct. 2011, accessed 9 August 2014 at <http://www.latkowski.com/tematy/121/stracil-firme-i-prywatny-majatek>; Interview with Jacek.

¹⁴¹ NPR #18

¹⁴² NPR #19

was based. The Supreme Administrative Court later overturned the KRRiT's decision to cancel Radio Blue's license, citing gross violations of the law by the regulator.¹⁴³

The final questionable takeover we will consider from the SLD era targeted Paweł, the owner of RTS, which is involved in the transportation and storage industry (both names are fictionalized on the request of my source).¹⁴⁴ To make the initial investment in RTS, Paweł, together with Russian partners, had formed a separate joint venture in a related business, ZMT. ZMT, in turn, provided capital to RTS and in exchange received 50 percent plus one share in latter, with Paweł owning the remainder. The Russian partners had invested in ZMT using an offshore firm based in Luxembourg, a notorious secrecy jurisdiction that allows companies to be anonymously owned. The importance of this fact will become apparent below.

Paweł was appointed manager of RTS while his Russian partners ran ZMT. Over the ensuing years, Paweł worked extensively with the director of ZMT. A certain level of trust developed on Paweł's part as they built factories together and exchanged money and goods. At one point, the Russian partners obtained Paweł's agreement for ZMT to invest in a factory on the premises of RTS, financing the investment with a \$2.4 million loan to ZMT from the Russians' Luxembourg vehicle. One day, Paweł's partners subsequently informed him that they actually had no affiliation whatsoever with this mysterious Luxembourg firm but, by chance, that they had been "informed" by the firm that it demanded its money back from ZMT. While certainly peeved by this sudden breach of trust, Paweł was confident that ZMT had sufficient funds to repay the loan - that is, until he discovered that his Russian partners had already stripped ZMT of all its assets and transferred them to their Luxembourg company, a company with which they now claimed to have no affiliation. Because Luxembourg has strict corporate secrecy laws, it was impossible for him to prove that his partners were indeed the owners of this offshore entity, an entity which not only owned the debt owed by ZMT but stole the money necessary to repay it.

Under normal circumstances, ZMT would have gone into bankruptcy liquidation but, as it turned out, this was not what his partners had in mind. Instead, representatives of the Luxembourg entity persuaded a judge to convert the debt owed by ZMT into equity - not in ZMT, but in RTS. This gave the offshore firm control of RTS, which Paweł is convinced was their ultimate goal all along. They manufactured a liability owed by ZMT to their Luxembourg company and tunneled ZMT's assets to prevent it from repaying the debt. This, in turn, enabled them to get their hands on real prize: RTS itself.

After the court ruling, the Luxembourg company - which Paweł's partners still claimed to have no connection with - owned 93 percent of RTS while Paweł's share had been reduced to a mere seven percent - not enough to exercise any decision-making control. Because I could not confirm that the agent of force involved - in this case, the bankruptcy judge - was actually colluding with Paweł's Russian partners, I cannot

¹⁴³ "Benbenek w grupie?" *Fakty*, 18 March 2004 (<http://fakty.interia.pl/news-benbenek-w-grupie,nld,797925>); "Jednoręki lobbysta Zbigniew Benbenek," *RMF 24*, 4 December 2003 (<http://www.rmfm24.pl/fakty/polska/news-jednoreki-lobbysta-zbigniew-benbenek,nld,99029>); Ireneusz Dańko, "Konflikt nadawców radiowych w Krakowie," *Gazeta Wyborcza*, 9 December 2003; "Media Rights," *Polish News Bulletin*, 10 December 2003; "Radio Blues," *Warsaw Business Journal*, 4 November 2002; "Two Radio Stations Lose Their Licenses," *IPR Strategic Information Database*, 5 August 2002; "Two radio stations denied broadcasting licences [sic]," *BBC Monitoring Media*, 25 July 2002.

¹⁴⁴ The following comes from an interview with Respondent #76

technically label this a criminal corporate raid. Nevertheless, it remains a cautionary tale of just how tenuous the property rights of investors in Poland can be.

Non-Plutocratic Raiding in the Post-SLD Era

While criminal corporate raiding particularly flourished under Poland's social-democratic governments, it continued to remain a phenomenon well after the fall of the last such coalition in 2004.

One company to fall under the raider's knife was Atrax, a seller of mobile phone accessories which was bankrupted by authorities in Gdańsk.¹⁴⁵ In 2006, the local Treasury Office, acting at the behest of Wrocław Prosecutor Robert Mielczarek, initiated an audit of Atrax. It discovered what it claimed was the underpayment of approximately PLN500,000 in taxes. This marked the beginning of a six-year battle with regional authorities that ultimately drove Atrax out of business. "From the beginning," according to *Rzeczpospolita*, "the company's owners, experts, MPs, and [*Rzeczpospolita*] pointed out that the Treasury's audit was carried out selectively and materials in favor of the owner were ignored." In 2012, prosecutors in Poznań concluded that the owners of Atrax had not committed any violations after all. By this point, its owner had already seen her business run into the ground. Ultimately, no action was taken against the officials who unlawfully destroyed Atrax. On the bright side, she did receive an official apology. It is unclear whether this made things better.¹⁴⁶

More recently, a criminal corporate raid nearly destroyed Griffin, a British-owned property developer in Warsaw.¹⁴⁷ In 2012, Griffin purchased a dilapidated communist-era building from the city in a prime location. It hoped to tear it down and construct an office tower in its place. Just after the Treasury Ministry sold the building to Griffin, the city's Capital Conservation Officer suddenly decided it was a historical landmark and could not be demolished. "It's a prime example of modernist architecture of the 1960s," claims Karol Guttmejer, the Conservation Office's Director. Generally-speaking, communist architecture tends not to garner recognition for its aesthetic beauty, as anyone who has traveled to the former Eastern Bloc would understand. The Polish Architects Association indeed chose to exclude the building from its list of communist structures worthy of preservation. Just to be sure, before handing over the \$36 million it paid for the property, Griffin had sought and received an explicit guarantee from the Conservation Office that the building was not under consideration for landmark status.

Just hours after receiving the money, however, the city of Warsaw reneged on its promise and placed the building in the landmark registry. Skeptics noted the time day it was entered into the registry: 11:40 pm, not a typical hour when city conservation officers are known to be slaving away at their desks. Moreover, the Conservation Office acted illegally by granting landmark status without first obtaining the necessary decree

¹⁴⁵ NPR #20

¹⁴⁶ Wojciech Wybranowski, "Bezkarne niszczą firmy," *Rzeczpospolita*, 6 February 2013 (<http://www.rp.pl/artykul/977947.html>).

¹⁴⁷ NPR #21. Unless otherwise noted, all information on the Griffin case comes from the following articles: Michał Wojtczuk & Iwona Szpala, "Emilia została zabytkiem 20 minut przed północą," *Gazeta.pl*, 16 October 2012; Iwona Szpala & Michał Wojtczuk, "Emilia już nie jest zabytkiem. Będzie wieżowiec?" *Gazeta.pl*, 9 January 2013; Marcin Sobczyk, "The Property Report: Developer in Landmark Battle in Warsaw," *The Wall Street Journal*, 31 October 2012.

from the Warsaw mayor, as required by law. What was behind the city's decision? The Museum of Contemporary Art had been leasing the property from the city prior to its sale. Griffin suspects that the museum connived with city authorities to let it continue residing there while it searched for a new home. In fact, it was the museum itself that initiated discussions with the Conservation Office on obtaining the landmark designation; "We thought that [the building] was an architectural concept that deserved some form of protection," explains Marcel Velez, the museum's Deputy Director.

Once Griffin learned of the city's decision to bestow landmark status, it cancelled the museum's lease. But the museum refused to leave. Nevertheless, the Conservation Office was eventually forced to rescind the landmark designation and allow Griffin to take full control of the property.

Criminal corporate raids have not only affected smaller businesses since the fall of the SLD; they have occurred at the highest levels of the corporate world. An example was the PiS government's attempt in 2006 to block the lawful takeover of BPH, a Polish bank, by Italy's Unicredito.¹⁴⁸ Unicredito had already purchased BPH and planned to merge it with Pekao, another Polish bank it owned. The takeover and merger had received all the necessary approvals from the European Commission. The Commission has exclusive control over competition-related matters in all EU member states. No matter; the Polish Treasury decided that the merger should not go forward, although it neglected to offer any rational reason why this blatant violation of EU law was at all justified. In the meantime, the Polish authorities froze Unicredito's shares in BPH pending a resolution to the matter. It was losing money every day as a result of its inability to operate this huge portion of its Polish banking arm. Clearly, somebody with an agenda was acting behind the scenes in collusion with Treasury officials to prevent the takeover from happening. However, the culprit's identity cannot be revealed here since my source-in-the-know refused to go on the record on this matter. Nevertheless, since the state's agents of force were illegally blocking the lawful acquisition of a major asset and paralyzing its entire cash flow, this incident does count as a criminal corporate raid.¹⁴⁹

Political Thugs and Raiding Among the Plutocratic Elite

The multitude of criminal corporate raids among the non-plutocratic elite puts Poland in the same league as Slovakia and Ukraine. In all three countries, the plentiful provision of soft budget constraints enabled the rise of political thugs who proceeded to help themselves to privately-owned businesses, as political thugs are wont to do.

However, Poland's *plutocratic* elite offers up a contrast to the other two countries. In particular, it contains a significantly lower proportion of political thugs than do the plutocratic elites of Ukraine or Slovakia. Most of the remainder are crony capitalists rather than entrepreneurs (Table 6.1 and 3.5). The substantially lower share of the plutocratic elite that consists of political thugs accounts for the similarly low incidence of raiding among this stratum as compared to Slovakia and Ukraine. Tables 6.7 and 6.8 list

¹⁴⁸ NPR #22

¹⁴⁹ "PiS's Controversial Attempts to Gain Control of Banks Raise Questions About Their True Purpose," *Polish News Bulletin*, 24 January 2006.

Table 6.7. Alleged Plutocratic Raids

Raid #	Target	Alleged Perpetrator	Pol. Thug?
1	PTC	Solorz	Y
2	Elektrim bondholders	Solorz	Y
3	Polskie Media	Solorz	Y
4	Poznań developer	Grażyna Kulczyk	Y
5	Optimus	Wejchert/Walter/Jakubas	Y

all the plutocratic raids I uncovered along with the raiding indicators that can be observed in each.

The majority of the plutocrats got their start in business during the late communist period, and a few even before that. Going into private business on a substantial level under communism could not be done without the prior approval of the SB, the main state intelligence agency. Such approval would only be forthcoming if one agreed to cooperate with the agency on an ongoing basis. Once such cooperation began, it typically led business actors down a path in which political connections would become at least as important as their own capital in their rise to wealth. Because these connections could be used to secure soft budget constraints, both political thugs and crony capitalists prospered in this sort of environment. The most successful made it into the plutocratic elite. Nevertheless, limitations of space confine us to a discussion of the political thugs only; we will only be able to cover a few crony capitalists.

Ryszard Krauze is a typical example of a businessman who, thanks to a single infusion of state resources, went from a relative nobody to become one of his country's richest individuals. Under the first social-democratic government (1993-97), his main company, Prokom, "signed the contract of a lifetime with the Social Insurance Board (ZUS), which was later extended by the anti-communist government formed by the Solidarity Electoral Action (AWS)."¹⁵⁰ Indeed, Krauze has enjoyed solid political connections with all of Poland's post-communist governments. He was thought to be among a small coterie of businessmen in the SLD's inner circle. He reportedly had close ties even with the virulently anti-establishment PiS which governed from 2005 to 2007. That was until he was caught leaking information to Andrzej Lepper, the populist leader of one of the PiS' coalition's partners. Lepper had fallen out with the PiS and became the target of a sting operation, information about which was allegedly supplied to Lepper by Krauze.¹⁵¹ The government subsequently launched an investigation of Krauze's role in the leak. For good measure it reopened an old case involving his dealings with a media firm that collapsed.¹⁵²

Krauze's translated his initial success into still-greater wealth, an example of the feedback effects between soft budget constraints and the rise of political thugs. Aside from ZUS, his companies have also won profitable contracts with other state-directed entities; "since the very beginning Prokom has had a lucky hand for lucrative contracts with state-controlled companies or government agencies, such as coal mines, TPSA,

¹⁵⁰ "Law and Justice at Gates of Krauze's Empire." *Polish News Bulletin*, October 16, 2007.

¹⁵¹ Interview with Respondents #74 and 75.

¹⁵² "How Being a Politician's Kin..."

Table 6.8. Alleged Plutocratic Raids: Confirmation Indicators

Indicator Key	
Indicator #	Description
1	Many domains
2	Spontaneous public actions
3	Unrelated offenses
4	Non-existent laws
5	Suspicious bankruptcy / redistribution
6	Repeated investigations/prosecutions
7	State action in midst of political conflict
8	Direct force
9	Threats made
10	State actions ruled (or suspected to be) illegal
11	Target is a rival of powerful interests
12	#2, 8, or 9 coincides with state action
13	Illegal board meeting

Raid #	Target	Alleged Perpetrator	Indicators													Substantiated?		
			1	2	3	4	5	6	7	8	9	10	11	12	13			
1	PTC	Solorz									X							Y
2	Elektrim bondholders	Solorz					X						X				X	Y
3	Polskie Media	Solorz/Wejchert									X		X				X	Y
4	Poznań developer	Grażyna Kulczyk																N
5	Optimus	Wejchert/Walter					X						X					Y

PZU, ZUS, NIK, the Finance Ministry, [and copper-exporter] KGHM.”¹⁵³ In October 2007 Krauze’s oil company, Petrolinvest, obtained a huge loan from state banks that enabled it to meet obligations on its operations in Kazakhstan and thereby avoid the revocation of its license there¹⁵⁴ (at the time, Krauze was thought to be in dire financial straits as a result of multiple criminal investigations and a messy divorce from his wife).¹⁵⁵ Because political connections with the state’s agents of force have proved so critical to Krauze’s business success, he has made a habit of hiring many of them after they leave their official positions. Some of the biggest recipients of his largesse have been veterans of the state intelligence agencies and elite military organs, among whom are Sławomir Petelicki, the former head of GROM, the military special forces unit, and Mieczysław Tarnowski, the former deputy chief of the ABW. Krauze also bought one-third of Grupa Grom, a company established by ex-GROM officers.¹⁵⁶

Another duo that allegedly rose to immense wealth on the back of lucrative soft budget constraints is Sławomir Smołokowski and Grzegorz Jankilewicz, co-owners of J&S. With a paltry starting capital of only two thousand dollars, the company was plucked from obscurity in 1993 to become the main intermediary in the sale of Russian oil in Poland. J&S, whose holding company is based in the tax haven of Cyprus, would

¹⁵³ Ibid.

¹⁵⁴ "Controversies Around Loan for Krauze's Oil Company." *Polish News Bulletin*, October 2, 2007.

¹⁵⁵ Interview with Respondent #89

¹⁵⁶ "Law and Justice at Gates..."; "Spies for Hire..."

buy the oil from Russian energy majors at a low price and sell it on to Polish refineries and the state oil transit company at higher prices. By 2006, it had a turnover exceeding \$10 billion and controlled the vast preponderance of oil supplies to the two largest Polish refineries (PKN Orlen and Grupa Lotos), as well as the entire flow of oil through the Druzhba pipeline to the Gdańsk port. What economic value J&S was actually adding through this arrangement remains unclear. In this respect, its role resembles that of RosUkrEnerg and similar trading companies in the supply of Russian gas to Ukraine.¹⁵⁷

Smołokowski and Jankilewicz have been the subject of intense speculation that they once worked for Russian intelligence (or even still do), although nothing has ever been proven in this regard. At the very least, many observers have a hard time believing that they could have inserted themselves into the Russian oil trade without the approval of the Russian government, although, once again, this has never been proven.¹⁵⁸ They certainly have enjoyed friendly relations with successive Polish governments. This tends to be useful when your firm depends for its very survival on state largesse. Jankilewicz faced allegations that his wife illegally funneled money to President Kwaśniewski under the pretense of donating to the infamous charity run by the President's spouse.¹⁵⁹ Media outlets and investigators, most notably the PKN Orlen commission established in 2002, accused the company of paying off oil refineries to refuse business to rival suppliers and bribing legions of policymakers and officials to keep the arrangement in place. Some of the individuals behind these accusations have faced media attacks and other forms of harassment. An assistant to the head of the PKN Orlen commission was detained on trumped-up espionage charges on orders from the same Warsaw Assistant District Attorney who in 2002 forged documents in an attempt to scuttle an investigation into J&S.¹⁶⁰

Smołokowski and Jankilewicz moved to Poland from Ukraine in the early 1990s. They received their Polish citizenship with lightening speed; Smołokowski obtained his within three months of submitting the application while Jankilewicz's citizenship was bestowed directly by President Lech Wałęsa. Soon thereafter they managed to convince Petrochemia Płocki, the predecessor of PKN Orlen, to buy oil from their tiny trading company. In 1994 and 1995, J&S signed contracts that effectively gave it control of three-quarters of the supply of Russian oil to Polish refineries and exclusive control over the transit of Russian oil to the Gdańsk terminal.¹⁶¹

J&S has repeatedly been the target of official investigations but each time it has emerged unscathed. An attempt by the organized crime unit of the ABW to investigate Jankilewicz and Smołokowski was allegedly blocked by Polish counterintelligence. Meanwhile, most every attempt to end J&S's virtual monopoly have been stymied despite a UOP report which concluded that its activities are "harmful to the economic interests of the Republic." According to an investigation by the Polish weekly *Wprost*, from 1995 to 2004 the country's refineries paid \$800 million more for their oil than they

¹⁵⁷ Jan Piński and Krzysztof Trębski, "Ropowisko," *Wprost*, 17 February 2006 (<http://www.wprost.pl/ar/86865/Ropowisko/>).

¹⁵⁸ Interviews with Respondents #70 and #83.

¹⁵⁹ "Shareholders of Polish Oil Trade Intermediary..."

¹⁶⁰ Jan Piński, "Panstwo mafia," *Wprost*, 30 September 2005 (<http://www.wprost.pl/ar/81259/Panstwo-mafia/>); Piński and Krzysztof, "Ropowisko"; Krzysztof Trębski and Jan Piński, "Dystrybutor polityczny," *Wprost*, 27 August 2004 (<http://www.wprost.pl/ar/65418/Dystrybutor-polityczny/>).

¹⁶¹ Piński and Trębski, "Ropowisko."

could have had they had access to alternative suppliers. In 1999, as the initial long-term contract between J&S and PKN Orlen was about to expire, Lukoil, the Russian oil company, offered to eliminate J&S as the intermediary in the sale of oil to the refinery. Its offer was spurned despite the fact that it had accepted all conditions demanded of it by PKN Orlen's management. The explanation for the refusal? A "lack of available processing capacity," said Krzysztof Cetnar, a PKN board member.¹⁶²

As the second contract was due to expire in 2002, the pattern repeated itself. In 2001, PKN Orlen completely ignored an offer from TNK-BP, Russia's third largest oil producer, to cut out J&S from the oil trade and supply the Polish refineries directly. This would have allowed PKN Orlen to buy the oil at substantially reduced prices; under the existing arrangement TNK-BP first sold the oil to J&S, which then sold it to Polish refineries at an extra \$17 per ton. Then, in 2002, the President of PKN Orlen, Zbigniew Wróbel, reportedly sought to dissuade the head of TNK-BP from selling oil directly to the Płock refinery. For a brief period, the exclusive rights of J&S to supply oil were broken when Russia's Yukos entered the market (this came after PKN Orlen's chief executive, Andrzej Modrzejewski, was famously arrested and detained in 2002, allegedly to prevent him from renewing the contract with J&S). Even then, however, Polish refineries began buying oil from J&S at the higher futures price instead of the lower spot price. According to one source, "It's hard to resist the impression that PKN Orlen is compensating J&S for losses arising after Yukos came into the market, reducing short-term purchases of oil." In any event, once the Russian government destroyed Yukos in 2004, J&S regained its virtual monopoly position.¹⁶³

Aleksander Gudzowaty, another political thug among the plutocrats, was a member of the communist nomenklatura. He once served as head of a *Textilimpex*, a CHZ that had a monopoly on the trade in textiles with the Soviet Union.¹⁶⁴ As such he was well-placed to make it in post-communist business. He started *Bartimpex* in late 1990, using his political connections in Poland and Russia to facilitate a deal between the two countries that ensured the continued supply of Russian gas to Poland. *Bartimpex* received a five-percent commission for its role in securing the agreement.¹⁶⁵ But it would be 1993 that would see Gudzowaty catapulted from relative obscurity to become Poland's richest man. In that year, he managed to insert *Bartimpex* as an intermediary in the lucrative gas trade between Russia and Germany. In essence, *Bartimpex*, in partnership with PGNiG and Russia's Gazprom, established another company, *Gas-Trading*. *Gas-Trading*, in turn, received a four-percent stake in *EuRoPolGaz*, which owned the Polish segment of the Yamal gas pipeline that stretches between Russia and Germany. The remaining ownership in *EuRoPolGaz* was to be evenly split between the Russian and Polish governments.¹⁶⁶ However, *Bartimpex* was effectively given managerial control of *Gas Trading* despite the fact that it was a minority shareholder.¹⁶⁷

¹⁶² *Ibid.*; Trębski and Piński, "Dystrybutor polityczny"; Piński, "Panstwo mafia."

¹⁶³ *Ibid.*

¹⁶⁴ Marek Matraszek, "The Man Who Would Be King." *Warsaw Business Journal*, February 11; "Home Grown Groups Take Leading Role in the Economy." *Polish News Bulletin*, October 28, 2002.

¹⁶⁵ Schoenman, "Captains or Pirates? State-Business Relations in Post-Socialist Poland," 61-62.

¹⁶⁶ "Talking Plenty of Gas." *Polish News Bulletin*, December 28, 2001; "Gas Trading May Survive." *Polish News Bulletin*, April 9, 2003; Matraszek, "The Man..."

¹⁶⁷ "Gudzowaty's *Bartimpex* Gains More Influence on Government." *Polish News Bulletin*, December 10, 2001.

How did Gudzowaty pull off this feat? A journalist recounted a story to me that Gudzowaty reportedly told him the day before we met. In the early 1990s, before Gudzowaty had any substantial fortune of his own, he invited a number of top Russian gas officials to Poland. He rented a mansion and brought over a bunch of bikini models. Sometime afterward, the Russian side agreed to bring him into the gas arrangement.¹⁶⁸

According to my source, Gudzowaty had excellent connections with the clique around former Russian President Boris Yeltsin and particularly those in control of the Russian energy sector. One of Gudzowaty's most important friends among this group was Gazprom chief Rem Vyakhirev. When Vyakhirev was ousted from his position after Putin came to power, Gudzowaty nearly lost his business.¹⁶⁹ This fact underscores just how important political connections were to Gudzowaty's success.¹⁷⁰

Late into his career, according to one source, Gudzowaty still insisted on being called "Director" by his employees. Nowadays, most businesspeople prefer the more Western "Chairman" given that they all employ scores of "directors." But Gudzowaty still preferred "Director" because this is how the boss was addressed during the good old days under communism. Back then, the title bestowed a certain status. It no longer does.¹⁷¹

When a single individual grows fabulously rich off a giant sweetheart arrangement with the state, it will inevitably attract some degree of controversy. Gudzowaty became the object of visceral hatred on the part of the rightwing Buzek government (1997-2001), which tried but failed to unseat him from the gas trade.¹⁷² Indeed, Gudzowaty has proven adept at maintaining good connections with almost every post-communist government as his very survival in business depends on that and that alone. He was known to wield much influence under Solidarity and its successor governments (1990-1993) as well the SdRP government that succeeded them (1993-1997).¹⁷³

Meanwhile, few businesspeople held greater sway over the SLD government of Leszek Miller (2001-2004). A parliamentary investigative committee unearthed evidence that Gudzowaty's bank extended a loan to Miller while the latter was Prime Minister. Gudzowaty's clout was thought to be the primary factor behind Miller's appointment of Kaczmarek as Treasury Minister.¹⁷⁴ Kaczmarek was later accused of having returned the favor by shepherding former Gudzowaty employees into ministerial positions and other key posts in the SLD government and state-owned companies.¹⁷⁵ Kaczmarek was also instrumental in preventing PGNiG's board from expelling Gas-Trading from EuRoPolGaz in 2001.¹⁷⁶

¹⁶⁸ Interview with Respondent #70.

¹⁶⁹ Ibid.

¹⁷⁰ For a similar view of the importance of political connections to Gudzowaty's success, see Schoenman, "Captains or Pirates? State-Business Relations in Post-Socialist Poland," 61-66.

¹⁷¹ Interview with Respondent #70.

¹⁷² Matraszek, "The Man."

¹⁷³ Ibid.

¹⁷⁴ "The Prime Minister's Private Promoters." *Polish News Bulletin*, November 28, 2002; Zybortowicz, "Anti-Development Interest Groups (Preliminary Outline)," 83.

¹⁷⁵ Matraszek, "The Man."

¹⁷⁶ "Gudzowaty's Bartimpex Gains..."; "PGNiG Sackings Spark Gas Row." *Platts International Gas Report*, January 3, 2003.

Later, in an attempt to curry favor with the populist-conservative PiS government, Gudzowaty secretly recorded a drunk Józef Oleksy, the former social-democratic Prime Minister, ridiculing his friends in the SLD. In addition to calling President Kwaśniewski a “little wanker” and Miller an “asshole,” Oleksy revealed how President Kwaśniewski’s wife channeled illicit donations to the party through her “charity” and portrayed the SLD as nothing more than a giant money-making operation.¹⁷⁷ His efforts apparently paid off. As the largest supplier of biofuels in Poland, Gudzowaty stood to gain from the 2007 Biofuels Act. Passed by the PiS-led coalition, it provides income-tax relief to biofuels makers and requires certain industrial processes to use biofuels.¹⁷⁸ Like Krauze, Gudzowaty has also turned his companies into something of a retirement community for high-level government officials after they lose power.¹⁷⁹

While many political thugs got their start in business in the 1980s, Jerzy Starak’s roots extend all the way back to 1977, when his Comindex was selected as one of three firms licensed to import much-needed goods to the country. Among other products, the Polish people had Starak to thank for introducing ketchup into the country. As early as 1980, he began collaborating with the SB, which reciprocated by helping Comindex secure business opportunities with the state in the ensuing years.¹⁸⁰

In another example of the feedback effects between soft budget constraints and the rise to wealth of political thugs, Starak was able to parlay his growing fortune into more extensive political connections and, in turn, expanded access to state resources. Because of his extensive political contacts, Starak was tapped a key partner by foreign firms such as Colgate-Palmolive looking to establish operations in Poland during the 1990s.¹⁸¹ A big break came in 2000 when he won the privatization of the Polpharma pharmaceuticals companies. While it did not rank among the top-ten privatizations, it certainly was in the top-20.¹⁸² The Polpharma sale gave Starak control of the country’s largest pharmaceuticals conglomerate.¹⁸³ In 2007 he sold his 99 percent stake in Polpharma to Hungarian drug-maker Gideon Richter, cashing out at \$1.34 billion.¹⁸⁴ Aside from pharmaceuticals, he also has extensive interests in edible oil production.¹⁸⁵

Like Gudzowaty and Krauze, Starak was a member of the SLD’s inner circle under Miller.¹⁸⁶ Success in pharmaceuticals production is highly dependent on political access since the Health Ministry chooses which medicines to put on its list of state-funded treatments. Starak proved more than adept securing access to such soft budget

¹⁷⁷ “Zapis rozmowy Oleksego z Gudzowatym,” *Dziennik.pl*, 10 December 2007

(<http://wiadomosci.dziennik.pl/polityka/artykuly/205396.zapis-rozmowy-oleksego-z-gudzowatym.html>).

¹⁷⁸ “Three Is Company in Biofuel World.” *Polish News Bulletin*, September 21, 2007.

¹⁷⁹ “Spies for Hire...”; Matraszek, “The Man.”

¹⁸⁰ “Jeden z najbogatszych Polaków spotykał się z SB,” *TVN 24*, 9 July 2007

(<http://www.tvn24.pl/wiadomosci-z-kraju,3/jeden-z-najbogatszych-polakow-spotykal-sie-z-sb,27523.html>);

“Fortunes of Business Elite Have Flourished from Firms Founded by Polish Emigrants,” *Polish News Bulletin*, November 24, 2006.

¹⁸¹ Interviews with Respondents #74 and 75; “Jerzy Starak,” *Wprost*

(<http://ludzie.wprost.pl/sylwetka/Jerzy-Starak/>).

¹⁸² If ranked by the method used in the privatization analysis (revenues the year before the privatization multiplied by the percentage sold), the privatization of Polpharma ranks at number 18.

¹⁸³ “Winner Takes All in Race for Medical Subsidies.” *Polish News Bulletin*, March 7, 2002.

¹⁸⁴ “Starak Made Deal of 2007 in Marrying Polpharma with Hungary’s Gedeon Richter

¹⁸⁵ “Number Six ? Jerzy Starak”; “Polish Mlekovita To Compete with Olvit for ZPT Warszawa Purchase”.

¹⁸⁶ “The Prime Minister’s Private Promoters”.

constraints, persuading the Miller government in 2002 remove several multinational firms from this list in favor of Polpharma.¹⁸⁷ The fact that Polpharma employed the son of Health Minister Marek Balicki until late 2003 may have helped.¹⁸⁸ Unlike Gudzowaty, however, Starak's relations with the PiS, which succeeded the SLD, proved poisonous. It was around this time that a scandal surfaced regarding his alleged collaboration with the communist secret services.¹⁸⁹ Nevertheless, his biofuels project benefited from the PiS coalition's Biofuels Act.¹⁹⁰

The plutocratic political thugs covered up to this point have not been implicated in criminal corporate raiding. A number of others have. Zygmunt Solorz is a classic example. "A reluctance towards organic investment is a common feature of many successful Polish businessmen such as Zygmunt Solorz or Bogusław Cupiał, who quickly jumped from heading small organisations to giant holdings generating profits calculated in billions of zloty," wrote one journalist.¹⁹¹

Like Starak, Solorz began his business career under communism and came into immense wealth on the back of soft budget constraints. While living in Germany as a Polish émigré, according to *Rzeczpospolita* journalist Wojciech Wybranowski, he began cooperating with Polish military intelligence in 1983. In return for his assistance, he benefited from business deals in the 1980s in the form of contracts with Polish state agencies, including one to supply cars to Polimar, a CHZ. After communism collapsed, Solorz' ties to the former intelligence agencies would pay off in spades. In 1990 he received a "loan" of PLN100 million from the FOZZ, in itself revealing his ultimate insider status with the former nomenklatura. Then, in 1992, his media company, Polsat (co-owned with Universal, which emerged from the grave of the former CHZ of the same name and was headed by one of the six FOZZ defendants), received the first country-wide TV broadcasting license awarded to a private station. The tender proved highly controversial, as relatively tiny Polsat somehow managed to beat out several large foreign providers.¹⁹²

Jacek Łęski summarizes Solorz's version of the story; "Basically, [he] started out as a small entrepreneur and needed a satellite license. Then one day he suddenly had in his account ten million dollars needed for this, and he didn't really know where it came from. He just doesn't remember where it came from."¹⁹³

The same political connections that enabled Solorz to prosper from soft budget constraints also served him well in his pursuits as a criminal corporate raider. Together with Deutsche Telecom, he was involved in a high-profile raid against France's Vivendi in a bitter struggle for control of Polska Telefonia Cyfrowa (PTC), the operator of

¹⁸⁷ "Winner Takes All in Race for Medical Subsidies".

¹⁸⁸ "How Being a Politician's Kin May Help Your Business Career".

¹⁸⁹ "Starak Made Deal of 2007 in Marrying Polpharma with Hungary's Gedeon Richter" *Polish News Bulletin*, January 22, 2008.

¹⁹⁰ "Three Is Company in Biofuel World."

¹⁹¹ "Catching up with Warren Buffet? Dream of Roman Karkosik, Polish Stock Market Prodigy." *Polish News Bulletin*, January 26, 2007.

¹⁹² Jan Cienski, "The Biggest Gamble for a Habitual Risk-Taker." *Financial Times*, December 7; Wojciech Wybranowski, submission to *Afery Prawa*, 26 October 2010, accessed 9 August 2014

(<http://www.aferyprawa.eu/Afery/Solorz-Zak-Zegarek-i-jeszcze-kilka-nazwisk-wlasciciela-platformy-POLSAT-agenta-SB-Zygmunt-Solorz-Zak-o-przkretach-aferyzisty-Zawiadomienie-CBA-ministra-Mariusza-Kaminskiego-1194>).

¹⁹³ Interview with Jacek Łęski.

Poland's largest mobile phone network.¹⁹⁴ In 1999, Elektrim, another former CHZ, bought a 51 percent stake in PTC. This brought Elektrim into joint-ownership of PTC with Deutsche Telecom, owner of the other 49 percent. Later, Elektrim invited Vivendi into the arrangement. Over the vociferous opposition of Deutsche Telecom, the two set up an Elektrim subsidiary, Elektrim Telekomunikacja, to replace the 51 percent stake in PTC formerly held by Elektrim.¹⁹⁵

Solorz became a party to this dispute in 2004 when he purchased the financially troubled Elektrim conglomerate. In early 2005, an arbitration court in Vienna issued a "confusingly written verdict" invalidating the deal that had established Elektrim Telekomunikacja, ruling that its shares in PTC actually belonged to Elektrim alone and not Vivendi. This threw into question Vivendi's entire multibillion dollar investment in the venture. Solorz and Elektrim moved quickly to take advantage of the ruling, siding with Deutsche Telecom in an effort to push Vivendi out of PTC altogether. In February 2005 they changed the PTC shareholder registry and got the change authorized by a Polish court. Immediately afterward they sent in a new management team accompanied by a group of burly security men to take control of PTC's headquarters in downtown Warsaw and expel Vivendi's managers. "This is something that is not normal," a Vivendi spokesman protested, "our property rights are not being observed. We clearly expect that what I call this continuous robbery will be stopped."¹⁹⁶

Later that year, Vivendi managed to get the change to the shareholder registry overturned and the old board reinstated. However, when the previously-ejected management returned to PTC's headquarters to reassume control, they found "dozens of beefy security guards" on hand who physically prevented them from entering the building. Brandishing documents showing that PTC's banks would only respect the authority of the new board, not the old, a Vivendi representative declared that "We can run the company from the outside until the powers that be, in charge of the country, resolve the situation. The only thing they control now is the entrance to their building."¹⁹⁷ In the end, Deutsche Telecom exploited a technicality buried in a previous agreement that enabled it to buy Elektrim's stake in PTC at book value.¹⁹⁸

Aside from the raid attempt on Vivendi, Solorz also tried to expropriate a consortium of bondholders by tunneling the most valuable assets out of Elektrim, whose assets constituted a security on the bonds.¹⁹⁹

In 1999, Elektrim issued bonds to finance various corporate acquisitions. However, the acquisitions went sour and put the company in serious financial jeopardy as a result. In response, Elektrim concluded a deal with the bondholders in 2002 that reduced the interest rate on the bonds, extended the repayment schedule, and voided a

¹⁹⁴ Plutocratic raid #1 (PR #1)

¹⁹⁵ Cienski, "The Biggest Gamble..."; Jan Cienski, "Companies International: Elektrim moves on PTC team." *Financial Times*, February 26; Martin Arnold, Jan Cienski, and Bettina Wassener. 2005. "Opponents Flex Muscles in PTC Tug-of-War." *Financial Times*, March 15.

¹⁹⁶ Ibid.

¹⁹⁷ Cienski, "The Biggest Gamble..."

¹⁹⁸ Jan Cienski, "Companies International: Elektrim loses control of PTC stake to rival DT." *Financial Times*, June 13; Ben Hall, Jan Cienski, and Gerrit Wiesmann, "Vivendi and D Telekom to settle Polish dispute," *Financial Times*, 15 December 2010 (<http://www.ft.com/intl/cms/s/0/c40d9c14-0839-11e0-8527-00144feabdc0.html>).

¹⁹⁹ PR #2

previous clause by which the bonds could be converted into Elektrim shares. This last point would prove critical; as compensation for relinquishing their right to convert the bonds into shares, the consortium members would receive a “contingency payment” amounting to approximately 25 percent of Elektrim’s total assets.²⁰⁰

Had the bondholders been dealing with a normal partner, this arrangement would have secured their claim on Elektrim’s assets. By 2004, however, they were no longer dealing with a normal partner; they were dealing with Zygmunt Solorz, who had bought a controlling stake in Elektrim earlier that year. The contingency payment would effectively give the bondholders 25 percent of Elektrim’s assets. But if Solorz could manage to strip the assets before the payment was due, the value of that 25 percent stake would not amount to much. “In the end, all that would be left would be an empty shell called Elektrim,” complained Mirosław Obarski, a spokesman for the bondholders.²⁰¹

Solorz’s first task was to remove the bondholders’ representatives from any supervisory role they might use to disrupt his asset-stripping scheme. He accomplished this in early 2004, ousting the consortium’s representative from the Elektrim board in a move later deemed prejudicial by a London Court.²⁰² The tunneling of Elektrim could now proceed without any interference.

The key assets Elektrim held at the time were a stake in PTC along with holdings in Pątnów-Adamów-Konin S.A. (PAK), a power plant; Port Praski, a real estate developer; and Rafako, a manufacturer of power boilers. Solorz first turned his attention to PAK. In 2005, according to representatives of the bondholders, shifted shares in PAK to entities he controlled through a complex series of share transfers, loans, and deliberately-manufactured defaults on these loans.²⁰³ Elektrim transferred its shareholding in PAK to an Elektrim subsidiary, Embud Sp. z.o.o., in lieu of repayment on a loan from Embud it had “defaulted” on. Two months later, Inwestycje Polskie, an entity personally controlled by Solorz, took control of Elektrim’s shares in Embud, the entity which by now had in its possession the shares in PAK.²⁰⁴

In response, the bondholders filed a petition for Elektrim’s bankruptcy in early 2005. But they would find their attempts to prevent the further tunneling of the company stymied by the bankruptcy court. In May of that year, the court dismissed their bankruptcy claim altogether.²⁰⁵ Later, in September, a Poznań court essentially invalidated the bondholders’ claim on Elektrim’s assets, ruling that no assets belonging to

²⁰⁰ More accurately, the amount of the contingency payment was to be 25 percent of the assets’ value above a certain minimum threshold. See “The Bondholders receive 504 million Euro resulting from Elektrim’s bonds,” *Committee of Bondholders Press Release* (Warsaw, 2 July 2007). For brevity’s sake, the amount will simply be noted here as 25 percent.

²⁰¹ Interview with Mirosław Obarski.

²⁰² Elektrim Committee of Bondholders, “Release on Behalf of the Informal Bondholder Committee: Bondholders to Accelerate the Bonds” (London, England: Elektrim Bondholders Committee); Elektrim Committee of Bondholders, “Release on behalf of the Elektrim bondholders: Elektrim bondholders concerned over PAK rights offering” (London, England: Elektrim Bondholders Committee).

²⁰³ Elektrim Committee of Bondholders, “Statement Regarding the Notification of Suspicion of an Offence Which May Have Been Committed by Persons Authorised to Represent Elektrim S.A.” (London, England: Elektrim Bondholders Committee, 2005).

²⁰⁴ Elektrim Committee of Bondholders, “Preparations for Tunneling the Assets of Port Praski from the Elektrim Group!,” (London, England: Elektrim Bondholders Committee, 7 September 2006).

²⁰⁵ Elektrim Committee of Bondholders, “Elektrim S.A. - Bondholders Will Continue to Protect Their Rights” (London, England: Elektrim Bondholders Committee, 20 May 2005).

the company could be transferred to the trust representing the bondholders. The individual who petitioned the court to make this decision was Dariusz Staszak, Vice Chairman of the PAK supervisory board, who some speculated to be Solorz's man. The Poznań court ruling "looked pretty much like an ace up the sleeve - pulled out whenever needed," according to the bondholders' representatives.²⁰⁶ Eventually, control of PAK, whose value was estimated at PLN 1 billion, was transferred to a Cyprus-based entity, Darimax, for a mere 10 million euros.²⁰⁷

Now that he had tunneled PAK, Solorz set his sights on PTC. In October 2005, Vivendi revealed that Elektrim had attempted to transfer its 48 percent stake in the mobile network to entities Solorz controlled. According to Vivendi and the bondholders, the PTC stake was transferred at a fraction of its true value, thus minimizing any resulting revenue for Elektrim and maximizing the value of what Solorz's entities were to receive.²⁰⁸ (Ultimately, Solorz would not be able to keep control of PTC due to his conflict with Deutsche Telecom - see above.)

Then, in 2006, Elektrim lost control of another key asset, Port Praski, to an offshore entity. In 2004, Port Praski took out a loan from the Elektrim subsidiary, Embud. Once again, a "default" took place, the result of which was for shares in Port Praski to transfer to Embud in lieu of repayment. Only by the time the default occurred, Embud was no longer a subsidiary of Elektrim; Solorz's company, Inwestycje Polskie, had already taken control of Embud away from Elektrim as a result of another transaction (see above). Later, Embud, which now owned the Port Praski shares, ended up in the hands of Cyprus-based Darimax, the same entity to which PAK was ultimately transferred (see above); Darimax acquired 99 percent of Embud for a mere USD 16 million, according to representatives of the bondholders. "A listed company transfers the ownership title of one of its assets immediately before its very probable bankruptcy; this is an uncomfortable truth," said Obarski.²⁰⁹

Next on the chopping block was Rafako. In 2007, Rafako's shareholders approved a new share issuance. Whenever new shares are issued in any company, it potentially threatens to dilute the stake of any shareholder who does not participate in the share offering by buying enough shares to maintain the size of its stake relative to the other shareholders. In this case, Elektrim did participate. But, to do so, it borrowed the money from a mysterious entity called Laris Investments. Naturally, Elektrim defaulted on this loan, allowing Laris Investments to take control of the shares in Rafako. "Elektrim's asset transactions are causing the value of its assets to drop and could be an attempt to decrease the final payment owed to the Bondholders...and to escape with its assets from other possible creditors", said Mirosław Obarski. By late April, Elektrim announced that the value of its Rafako shares had decreased by PLN238 million. The cause of the decline was the fact that a huge portion of Rafako's shares had now transferred to Laris Investments in lieu of repayment of the loan.²¹⁰ Ultimately, the stake

²⁰⁶ Elektrim Committee of Bondholders, "Elektrim - major events around the company and the bonds" (Warsaw, Poland: Elektrim Bondholders Committee).

²⁰⁷ Vivendi, "Why Did Elektrim File a Petition in Bankruptcy?" (Paris: Vivendi, 21 December 2007).

²⁰⁸ Ibid.; Cienski, "The Biggest Gamble..."

²⁰⁹ Elektrim Committee of Bondholders, "The Assets of Port Praski Were Outside of Elektrim Capital Group" (Warsaw: Elektrim Bondholders Committee, 6 August 2007).

²¹⁰ Elektrim Committee of Bondholders, "Elektrim S.A. Has Decreased the Value of Its Assets by 238 Million PLN" (Warsaw: Elektrim Bondholders Committee, 19 March 2007); Elektrim Committee of

in Rafako ended up in the hands of Darimax, the same Cyprus-based entity that now controlled PAK and Port Praski (see above).²¹¹

How was Solorz able to get away with all of this? A clue emerged when his former employee, Krzysztof Bondaryk, was appointed as head of the Internal Security Agency (ABW) in 2007 after the new Civic Platform government assumed power. Before going to work for Solorz, Bondaryk had served in the state intelligence agencies. When he returned to the ABW, he was still receiving regular severance payments from one of Solorz's companies. As a result, few observers were surprised when, upon assuming his new post at the ABW, Bondaryk immediately suspended an ongoing investigation into Solorz's dealings at Elektrim.²¹² Not only that, but the bondholders' efforts were consistently stymied by the Polish courts, which issued "a number of recent decisions in these proceedings that are irrational at any level" and "seek to discriminate against the bondholders." The Court Supervisor, who is charged with protecting "the interests of the bankrupt estate and its creditors," in this case "sought to do neither," representatives of the bondholders said. "This means he has not acted in accordance with his responsibilities under statute."²¹³

As the raid on Vivendi indicated, Solorz does not shy away from using force to resolve business disputes. In June 1999, Solorz's Polsat undertook a raid against the controlling shareholder of Polskie Media SA, owner of the Nasza TV broadcasting station.²¹⁴ That summer, a disputed shareholders meeting was held that evicted the existing board under Henryk Chodysz and replaced it with representatives of Polsat and TVN. The old board then held another meeting at which it reinstated itself in control of the company. That meeting featured a violent clash on the building steps between rival security teams representing the two sides. The scuffle had to be broken up by police. Chodysz was able to obtain a court decision that invalidated the removal of his board and the Nasza TV management on the grounds that it had been unlawful. No mere court decision would thwart the plans of Solorz. "While the courts have ruled succinctly on the issue," wrote one news report, "neither Nasza's current managing board nor the Radio and Television Council (KRRiTV) has paid any attention to the decision." Solorz prevailed in the end, renamed the channel TV4, and it remains a part of his media empire to this day.²¹⁵

In another example of feedback effects, Solorz has been able to turn his success in raiding into expanded political influence and additional soft budget constraints. Between 2006 and 2011, the state telecoms regulator, UKE, then under Anna Streżyńska, issued a number of decisions that benefitted certain mobile providers at the expense of

Bondholders, "Bondholders Afraid of Another ZE Pak Story" (Warsaw: Elektrim Bondholders Committee, 23 March 2007).

²¹¹ Vivendi, "Why Did Elektrim..."

²¹² "Civic Platform's Troublesome Secret Service," *Polish News Bulletin*, 4 December 2008; "Polish President's adviser discusses "conflicts of interest" in secret services," *BBC Monitoring European*, 26 July 2009.

²¹³ Elektrim Committee of Bondholders, "Bondholders of Elektrim S.A. Seeks Redress against the Republic of Poland" (Warsaw: Elektrim Bondholders Committee, 10 November 2007).

²¹⁴ PR #3

²¹⁵ "More troubles for Nasza TV," *Polish News Bulletin*, 2 July 1999; Anna Kocinska, "SBS takes another look at Nasza in quest to enter Poland," *Warsaw Business Journal*, 7 February 2000; Anna Kocinska, "Many obstacles stand in way of Nasza/Polsat teaming," *Warsaw Business Journal*, 6 March 2000.

Telekomunikacja Polska (TP SA), the dominant network operator in the country. Under the guise of increasing competition in the telecoms sector, Streżyńska granted the Polish subsidiary of Tele2, the multinational telecoms firm, access to TP SA's fixed-line telecoms infrastructure. However, UKE set the wholesale price that Tele2 had to pay TP SA at a level below the latter's operating costs.²¹⁶ Another company to receive such preferential treatment was Play, part-owned by an Icelandic businessman alleged to have made his fortune in cahoots with Vladimir Putin when the future Russian President was governor of St. Petersburg.²¹⁷

Solorz was also alleged to have benefited. In 2008, another tender for TP SA network access was scheduled to be held. Solorz's own telecoms company, Sferia, could not participate without incurring financial penalties since the additional line access would place its bandwidth above regulatory limits. An apparent solution emerged with the establishment, just days before the tender, of a company called Aero 2. Boasting a mere €12,000 in initial capital, it was officially owned by Solorz's law firm. Despite its obvious ties to Solorz, UKE decided to treat Aero 2 as an independent entity for the purpose of the competition, and Aero 2 ended up winning the tender. Companies linked to Solorz were thus able to increase their network access without having to bear the additional costs (in the form of penalties) mandated by competition regulations: a classic soft budget constraint. In 2011 Solorz bought two additional companies that had won previous UKE tenders, further boosting his control of the country's telecoms network. Today, companies linked to Solorz control more bandwidth than the other three providers combined.²¹⁸

One of Solorz's most trusted advisers since the 1980s is Heronim Ruta, who owns shares in a number of Solorz's companies and sits on their supervisory boards. In 2008, he became an instant plutocrat after Solorz essentially gifted Polsat shares to him worth almost PLN500 million for the nominal price of PLN7 million. Given that his rise to wealth so closely paralleled that of Solorz and his important advisory role as part of Solorz's inner circle, he is considered a political thug – and raider – for the purpose of this study.²¹⁹

Like many other Polish plutocrats, the roots of Jan Kulczyk's fortune reach back to the murky business world of the 1980s when no private company of any significance could operate without official sanction. Soft budget constraints would be instrumental to his rise. His father, Henryk, had emigrated to Germany after World War II when the communist authorities expropriated his family's business. In 1981, under the reforms of the Jaruzelski military government, Henryk returned to Poland to found Interkulpol.²²⁰ Jan joined his father upon completing his PhD. Interkulpol went on to make a small fortune exporting prefabricated houses built with cheap labor and subsidized wood.²²¹ A

²¹⁶ "TP SA's market clout undermined by regulator," *PMR Publications*, August 2006

(<http://www.pmrpublications.com/press-releases/49/tp-sas-market-clout-undermined-by-regulator>).

²¹⁷ Correspondence with Respondent #72.

²¹⁸ Correspondence with Respondent #72.

²¹⁹ Tomasz Prusek and Vadim Makarenko, "Hojny Solorz Podarował Koledze Miliony," *Gazeta.pl*, 15 May 2008; "100 Najbogatszych Polaków Edycja 2009: Heronim Ruta," *Wprost* <http://100najbogatszych.wprost.pl/obiekt/id,2209/ide,21/idk,0/edycja-2009-Heronim-Ruta.html> (accessed 16 July 2014).

²²⁰ "Jan Kulczyk," *Historia Biznesu*, 14 May 2012 (<http://historiabiznesu.pl/jan-kulczyk>).

²²¹ "Fortunes of Business Elite Have Flourished..."

clue as to how Interkulpol managed to obtain such advantageous state support became evident when both Jan and his father appeared on the famous list of secret-police collaborators published by Polish journalist Bronisław Wildstein.²²²

In 1988, Jan established Kulczyk Trading, which became the sole authorized Volkswagen dealer in Poland. This paved the way for the deal that really vaulted Kulczyk into the ranks of the richest Poles; in 1992, Kulczyk Trading, without any competition, was awarded a major contract worth PLN150 million to sell 3000 cars to the Ministry of Interior.²²³ The firm allegedly won this contract with the help of a former SB agent in the Warsaw police.²²⁴

In Kulczyk's business dealing, the state has frequently been the one taking the other side of the transaction. The soft budget constraints afforded to Kulczyk as a result of these deals have often been marred by scandal. A former senior official at PBR bank confirmed to me that the state-owned bank, then under Wojciech Kostrzewa, granted Kulczyk's companies soft loans that greatly facilitated his initial ascent in the Polish business world. At one point, upwards of 40 percent of PBR's assets consisted of loans to Kulczyk's firms.²²⁵ In 1993, he privatized a 40 percent stake in the Wielkopolskie Brewery. The PLN20 million he paid for the stake was widely regarded as excessively low.²²⁶

In the mid-1990s, Kulczyk took part alongside Elektrim (still state-owned at the time) in the purchase of one of the first mobile telephone licenses awarded by the state. That purchase formed the basis of PTC, which would become the country's largest mobile telephone operator. However, a scandal erupted in 1998 after revelations surfaced of a secret deal whereby Elektrim arranged to sell Kulczyk Holding a portion of its PTC shares at a bargain price.²²⁷

Kulczyk has established himself as an essential partner for foreign investors seeking access to major Polish privatizations. In 2000, a consortium between Kulczyk Holding and France Telecom won the privatization of TP SA, the fixed-line telecoms network provider. However, many suspected that the only value Kulczyk offered the French giant was his political connections, which allegedly enabled France Telecom to edge out its rival, Telecom Italia. Kulczyk actually borrowed the money to finance his part of the purchase from France Telecom itself, allowing him to earn a fortune on the transaction without investing any money of his own.²²⁸ As with Elektrim, a secret deal with the state similarly marked the purchase of TP SA; in June 2001, it emerged that the telecoms minister in the right-wing AWS government secretly committed the state to preferential regulatory treatment of TP SA, the guaranteed provision of future mobile

²²² The list is available at http://www.ny.pl/Lista_Wildsteina/k/ku.html.

²²³ Daniel Gąsiorowski, "Jan Kulczyk, tajemniczy biznesmen," *Money.pl*, 13 March 2006 (<http://manager.money.pl/ludzie/portrety/artukul/jan;kulczyk;tajemniczy;biznesmen,23,0,145175.html>); Dariusz Malinowski, "Na czym Jan Kulczyk zarabiał najwięcej," *Gazeta.pl*, 9 November 2004 (<http://wiadomosci.gazeta.pl/wiadomosci/1,114871,2384673.html>).

²²⁴ Interview with Respondent #68.

²²⁵ Interview with Respondent #80.

²²⁶ Dariusz Malinowski, "Na czym Jan Kulczyk..."

²²⁷ Williamson, "France Telecom, Kulczyk Holding Link Up..."

²²⁸ Dariusz Malinowski, "Na czym Jan Kulczyk..."; Williamson, "France Telecom, Kulczyk Holding Link Up..."; Interview with Respondent #80; Interview with Respondents #74 and 75.

telephone concessions to the company (despite the fact that the tender had not yet been held), and a guaranteed monopoly for TP SA until the end of 2002.²²⁹

Kulczyk was known to have especially close ties with Leszek Miller's SLD government. Most notably, he allegedly acted on behalf of Lukoil to help reopen the privatization of the Gdańsk Oil Refinery (later renamed Grupa Lotos), using his influence with President Kwaśniewski and supplying Lukoil with a list of Polish politicians that had to be bribed.²³⁰ In addition, Kulczyk reportedly had links to Jeremiasz Barański, the notorious leader of the Pruszków underworld alleged to have been behind the assassinations of Marek Papała, the country's top police official, and Jacek Dębski, the former Sports Minister.²³¹

Kulczyk's wife, Grażyna, is a powerful political thug in her own right and another member of Poland's plutocrats. She too has benefited from soft budget constraints; in 2007, the mayor of Poznań was forced to resign over a scandal involving the sale to her of municipal land.²³² While I have not yet been able to confirm it, another source implicated her in a criminal corporate raid; "Don't go up against Grażyna Kulczyk in Poznań," he warns. "There was a guy developing real estate - apartments - near one of her projects and he basically got run out of town."²³³

While many Polish businesspeople got their start in the 1980s, Jan Wejchert, who died in 2009, is one of the few whose roots went back as far as the 1970s. In 1977, Konsuprod, a German firm that Wejchert represented in Poland, was one of three companies awarded special licenses to conduct international trade with Polish state agencies. Of course, this privilege came at a price; Wejchert's name too appeared on Wildstein's list of secret-police collaborators.²³⁴ Jaruzelski's reforms in the 1980s created expanded opportunities for Wejchert. To pursue them he linked up with future fellow-plutocrat Mariusz Walter. At the time, Walter was a prominent television journalist and program director. The two partners formed ITI in the early 1980s and began importing electronics equipment and distributing films and VHS cassettes.²³⁵ Wejchert and Walter have faced accusations, which they deny, that ITI was founded with financing from the FOZZ.²³⁶

ITI has been linked to at least one criminal corporate raid. The company was the ultimate beneficiary of the notorious raid on Roman Kluska and his firm, Optimus.²³⁷ However, the immediate orchestrator of the raid was another plutocrat, Zbigniew Jakubas, and his partner, Wojciech Kostrzewa. Political connections have clearly played a role in Jakubas' business career. One does not attain the status as the biggest taxpayer in communist Poland in the year 1982 without the help of political contacts along the

²²⁹ Schoenman, "Captains or Pirates? State-Business Relations in Post-Socialist Poland," 67.

²³⁰ Wagstyl, "Polish Businessman Warns..."; "Mountain Giving Forth a Mouse..."; "Ivan at the Pipe"; Dorota Bartyzel and Katya Andrusz, "Spy, Tycoon, LUKoil Stir Up Polish Politics," *The Moscow Times*, 25 October 2004 (<http://www.themoscowtimes.com/business/article/spy-tycoon-lukoil-stir-up-polish-politics/227483.html>).

²³¹ "Kulczyk's Counsel in Bad Light..."

²³² Interview with Respondent #66.

²³³ PR #4. Interview with Respondent #89.

²³⁴ For the list, go to <http://www.listaipn.pl/>.

²³⁵ "Fortunes of Business Elite Have Flourished..."

²³⁶ "An uneasy mix." *Broadband TV News*, March 2, 2007.

²³⁷ PR #5

way. During the 1980s he began importing computers as well as materials to manufacture clothing, another privilege that could typically come only with the permission of the state intelligence agencies. In the post-communist period, too, he has participated in various companies whose success depended on state contracts, including the Polish Mint (which produces all coins issued by the central bank) and a company supplying railway cars and equipment. He gained control of the Polish Mint thanks to a decision by the authorities not to apply anti-monopoly rules. However, most of his business enterprises clearly generated economic value. He built a mineral water plant which he later sold to Coca-Cola. He eliminated pervasive tunneling schemes at the Polish Mint. And he helped restructure Elektrim.²³⁸

Jakubas is a relatively rare case of a crony capitalist who has benefitted from raiding – in his case, the 2000 takeover of Optimus.²³⁹ At the time, Optimus was Poland's largest and most successful IT firm. For many, Kluska, its founder, represented the ideal of a self-made businessman who rocketed to the top by constructing his empire from scratch. Along with Jakubas, the other protagonist in the raid was BRE Bank, headed by Wojciech Kostrzewa. Many believe that Kluska was pressured to sell Optimus to BRE Bank. After all, the sale, completed in 2000, was done at a 30 percent discount to Optimus' share price at the time.²⁴⁰ One of my sources who previously worked with Kostrzewa put it this way:

It was not very rare for people connected to the secret services, when they noticed some business, to acquire it. I know of a situation where people from the secret police came to a businessman with a proposal: 'We want your business.' In such a situation you have two choices. You can sell the business at a price attractive to them, or you can fight. But to fight them is very dangerous and you may lose everything, including your life...Kluska was pressed by these people, and he then decided to sell a controlling stake in his company, a very attractive company during the internet bull market, at 30 percent below the market price. Can you imagine? Would you like to sell a controlling stake in a financially sound company at 30 percent below the market price? Mr. Kluska is not a stupid guy. I know him. There was an outside agent who pressed him, who forced him to do it.²⁴¹

After the takeover, BRE Bank and Jakubas split Optimus into two parts - a computer manufacturer and the Onet.pl internet portal, Poland's largest. In early 2001 – within months of acquiring Optimus – they sold Onet.pl to ITI at well below its market value. Kostrzewa was later appointed President of ITI in a move widely seen as a reward for his services. Others noted his pre-existing relationship with the conglomerate; while head of

²³⁸ Joanna Solska, "Kto Ma Akcje, Ten Ma Rację," *Polityka*, 13 August 2005; Aleksandra Stranek, "Polski Buffett i Patriota Gospodarczy, Czyli Rzecz O Zbigniewie Jakubasie," *Biztok*, 16 November 2013; Anita Błaszczak, "Kariera Porysowana Nożykiem," *Rzeczpospolita*, 31 March 2006.

²³⁹ Solska, "Kto Ma Akcje..."

²⁴⁰ Witold Gadomski, "Turbo Menedżer," *Gazeta Wyborcza*, 30 October 2002 (http://www.archiwum.wyborcza.pl/Archiwum/1,0,1883145,20021030RP-DGW_D_TURBO_MENEDZER,.html); Interview with Respondent #80.

²⁴¹ Interview with Respondent #80; Witold Gadomski, a prominent investigative journalist, confirmed that it was Kostrzewa and BRE Bank who were behind the raid on Optimus (Interview with Witold Gadomski).

PBR in the 1990s, Kostrzewa was responsible for approving substantial loans to ITI along with TVN, one of ITI's major holdings.²⁴²

Kluska not only had to relinquish control of his business; he was later arrested and jailed on trumped-up charges. Even though BRE bought Optimus for what was an absurdly low price at the time, its stock price subsequently collapsed after the bursting of the tech bubble in 2000. The same source quoted above believes the arrest was undertaken as revenge for a losing investment: "This guy [Kostrzewa] lost hundreds of millions of dollars! This transaction was only one example of how he burned money. He burned millions of dollars! Millions of dollars! And what was the outcome? He is the President of the biggest media holding in Poland! And what did he do afterwards? When he noticed that he lost millions of dollars buying these shares from Kluska, he decided to finish him off. Why? Because there weren't any more assets that could be stolen [from Optimus] in order to offset the loss. So what did he decide? He decided to punish Kluska personally."²⁴³

BRE and Kostrzewa (who is not a plutocrat) have been linked to other raids as well - most notably the takeover of Pozmeat, a publicly-listed company.²⁴⁴ Andrzej Wachnik, Pozmeat's President, engineered a number of extraordinarily bad financial decisions that bankrupted the firm. His decisions allowed for the sale of its assets at rock-bottom prices to companies linked to BRE. In particular, Pozmeat had taken out a PLN1.3 million loan from BRE. From the beginning, the loan had been fully secured by Pozmeat assets; in the event of default, the assets would go to BRE Bank. Nevertheless, in 2001, Wachnik, acting without informing the board, signed another agreement with BRE. The new agreement pledged all of Pozmeat's shares in Millennium Center, a highly valuable subsidiary worth PLN100 million, as further collateral on the loan. Pozmeat's other creditors and minority shareholders questioned why it was necessary to pledge assets worth 100 times the value of the loan, especially when the loan was already adequately secured to begin with. Eventually, Millennium Center was sold to Tele-Tech, a company part-owned by BRE, for 40 percent of its estimated value. The money for the purchase was supplied by BRE itself through a clever piece of financial maneuvering. Later, the bankruptcy trustee noted that "there were strong relationships, both personal and financial," between Pozmeat, Tele-Tech, and BRE. Ryszard Jach, a Pozmeat board member representing the interests of minority shareholders, lambasted BRE for its handling of the company:

...it is clear that the actions of BRE Bank, which for four years held effective control of Pozmeat, not only contributed to the collapse of a company operating in an attractive industry, equipped with a very modern plant, but also violated the legally protected interests of creditors of Pozmeat as a result of the sale of the Millennium Center shares. This is an unprecedented situation in the history of the Polish capital market: a bank which is also a creditor and a shareholder of a public

²⁴² Gadomski, "Turbo Menedżer"; Interview with Respondent #80; "Specbankier Kostrzewa," *Neon24.pl*, 9 June 2011 (<http://monsieurb.neon24.pl/post/16359.specbankier-kostrzewa>); "Media Group ITI Appoints Former BRE Bank Chief as New CEO," *Polish News Bulletin*, 7 January 2005.

²⁴³ Interview with Respondent #80.

²⁴⁴ NPR #23

company controlled by its board knowingly and intentionally, to the detriment of the debtor and other creditors, taking the most valuable component of its assets.

It was decisions like these that were responsible for Pozmeat's rapid descent from a highly profitable food processor in 2001 to a financial black hole practically overnight.²⁴⁵

Why would Wachnik make such a disastrous decision? According to Emilia Nowaczyk, another Pozmeat board member, the objective was the same as in so many other raids: to get control of the real estate. "Unofficially, there was talk of a group of people who had their eye on the area," she confirmed. In February 2005, a court declared Pozmeat bankrupt. Its remaining assets were sold through the bankruptcy process to the same company that hired Andrzej Wachnik after he departed Pozmeat. "First he led the company to bankruptcy, and then he recommended the purchase of the company's new factory at a reduced value," Nowaczyk complained. Law enforcement agencies became aware of the possible fraud at Pozmeat as early as 2001. However, prosecutors have twice suspended investigations - first in December 2006 and again in 2007 after the Appellate Prosecutor's Office ordered the case reopened. Nowaczyk suspected foul play on the part of Wachnik and his allies. In particular, she noted, "the possible involvement of his brother, Marek Wachnik - the former deputy head of the ABW [Internal Security Agency] - should be clarified as soon as possible." Marek Wachnik denied involvement; "I had nothing to do with this case; it is nonsense."²⁴⁶

Kostrzewa came to Poland from Germany in 1989. Soon afterward, Balcerowicz appointed him as his deputy and then as head of the state-owned Polski Bank Rozwoju (PBR). This was despite the fact that Kostrzewa was only 29 years old, fresh out of school, and had no prior banking experience. At the same time, he represented the Ministry of Finance on the Supervisory Board of Bank Rozwoju Eksportu (BRE). PBR was acquired by BRE in 1998, after which Kostrzewa was appointed President of the bank. BRE had been established in 1986 to help channel foreign currency to the cash-starved communist regime. Kostrzewa's mentor at BRE was Krzysztof Szwarz, its previous President, who had a long history in the communist establishment, most notably as head of Impexmetal, one of the largest CHZs. From the beginning, prominent socialist party officials would serve in prominent roles at the bank, either on the board or in companies that bought stakes through privatizations. Under Szwarz's stewardship the bank would fall under suspicion for having misappropriated state funds. As his deputy at BRE he appointed Stanisław Pacuk, who would later serve as President of Kredyt Bank, the same bank suspected of orchestrating the raids on the Lublin Brewery, JTT Computers, and CLiF (see above).²⁴⁷

BRE was not engaged in retail banking; rather, it "earned money on big credits for big companies," in the words of journalist Witold Gadomski. Given its role, the bank and, by extension, Kostrzewa, were firmly ensconced among the Polish business elite. Kostrzewa at first gained accolades for his management of BRE. But he later built up an

²⁴⁵ Przemysław Poznański, "Syndyk Pozmeatu skarży BRE," *Gazeta Wyborcza*, 8 September 2005 (http://www.archiwum.wyborcza.pl/Archiwum/1,0,4461266,20050908RP-DGW,Syndyk_Pozmeat_skarzy_BRE,html); Piotr Nisztor, "Wymiar Sprawiedliwości," *Rzeczpospolita*, 16 February 2008.

²⁴⁶ Nisztor, "Wymiar Sprawiedliwości"; "Raw deal for Pozmeat shareholders as executives file bankruptcy papers in court," *Warsaw Business Journal*, 28 September 2004.

²⁴⁷ Gadomski, "Turbo Menedżer."

impressive resume of damaging a series of once-valuable companies through alleged fraud. In one case, he expelled the highly-experienced Ryszard Jach from the board of Skarbiec, a pension fund. Jach's removal, his denial of due compensation, and, according to Jach, his subsequent blacklisting from employment at other major Polish firms came after he refused to go along with an ongoing fraud perpetrated by senior Skarbiec officials. Later, Kostrzewa's bank was accused in the press of having stripped the choicest part of Best, one of BRE's debtors, "leaving nothing but the dregs left," according to Gadomski. In addition, the raid on SSPH, the shipyard operator noted previously, was made possible by a sudden loss of liquidity. Responsibility for that liquidity squeeze rested with Kostrzewa's BRE, one of SSPH's creditors, which seized money in the company's accounts. Last but not least, of course, was Optimus, as noted above.²⁴⁸

"Any attempts to challenge Kostrzewa's methods in court ended in fiasco," wrote one commentator. "What's more, an attempt to examine Kostrzewa by an inquiry committee on banking privatization ended in this commission being dismantled by the Constitutional Court." One of the judges who led the attack on the committee was a former board member at Kostrzewa's employer, ITI, who had received PLN 1 million in compensation from ITI the previous year. In other words, a committee looking into conflicts of interest was abolished by judge who himself had a conflict of interest in the conflict-of-interest case under consideration.²⁴⁹

Crony Capitalists and Entrepreneurs

The main feature that distinguishes Poland's plutocratic elite from those of Ukraine and Slovakia is its lower share of political thugs and its much higher proportion of crony capitalists and entrepreneurs (when the two categories are considered as a group). While space does not permit an overview of all of these business actors, this section will provide a few examples of each.

Beginning with the crony capitalists, Józef Wojciechowski built JW Construction, which constructs budget homes, into one of the two leading real estate developers in Poland. But real estate development is highly politicized and necessitates good political connections to ensure the smooth granting of permits. JW Construction's success required the help of numerous well-placed officials along the way whom he later hired at important posts at the company.²⁵⁰

Mariusz Świtalski has come a long way since serving prison time in the 1980s for burglary. After his release from jail he founded Elektromis in 1987, which made a fortune importing computers. Importing on such a scale under communism typically required the proper connections. After communism's end, a large part of the profits of Elektromis and Świtalski came from soft budget constraints; in 1995, his bank, Posnania,

²⁴⁸ Witold Gadomski, "Turbo Menedżer," *Gazeta Wyborcza*, 30 October 2002 (http://www.archiwum.wyborcza.pl/Archiwum/1,0,1883145,20021030RP-DGW_D,TURBO_MENEDZER,.html); Izabela Kordos, "Gazeta Bankowa: Jak sąd zalegalizował niewypłacanie wynagrodzenia," *wGospodarce.pl*, 3 January 2013 (<http://wgospodarce.pl/informacje/1603-gazeta-bankowa-jak-sad-zalegalizowal-niewypłacanie-wynagrodzenia>).

²⁴⁹ "Specbankier Kostrzewa," *Neon24.pl*, 9 June 2011 (<http://monsieur.neon24.pl/post/16359,specbankier-kostrzewa>).

²⁵⁰ Urszula Szyperska, "Buduje, to Ma," *Polityka*, 6 April 2007.

collapsed, leaving Świtalski on the hook for a trillion old zlotys in debt. Various personnel at Elektromis were later prosecuted for tax evasion and other financial irregularities. But Świtalski escaped responsibility since, officially, he merely served as the head of the company fire brigade. However, by that point he had already built up Elektromis into a solid company, as evidenced by the fact that he managed to sell it that same year to a foreign investor. He invested the proceeds from the sale of Elektromis into Biedronka, the country's first successful chain of discount retail stores. He eventually sold Biedronka as well and has since gone into real estate development.²⁵¹

Zbigniew Komorowski made a fortune in food production and, later, biofuels. "In his career," wrote *Rzeczpospolita*, "Komorowski was helped not only by the persistence, diligence, and consistency for which he is praised by friends and colleagues. His success, which came in the agro-food sector, is also due to political contacts." He was a two-time senator and then an MP. In the early 1990s he founded a dairy company alongside the infamous Eduard Mazur, who was suspected of ordering the murder of Poland's former police chief. But to all appearances his investments have created real value.²⁵²

In addition to the crony capitalists above, other members of the plutocratic elite are entrepreneurs. Dariusz Miłek rose from modest beginnings. Starting from a single shoe stall at a Lubin market, he went on to build CCC, the largest shoe retailer in the country. During its rise, CCC successfully displaced Germany's Deichmann, its main rival, from the Polish market. Miłek took the company public in 2004 and it has since expanded into 14 countries.²⁵³

The fact that Bogdan Kaczmarek began his career in the late 1980s importing clothes is somewhat suspect, as the right to import at the time was generally reserved to those with the necessary connections. However, his subsequent success - with the Big Start Jeans brand and as a manufacturer of furniture for all of IKEA's European branches - clearly did not depend on politically-obtained largesse.²⁵⁴

Jarosław Pawluk created one of the biggest railways logistics companies in Europe, transporting goods both within Poland and abroad. He built CTL Logistics from scratch beginning in the early 1990s with the help of employees he poached from Polish State Railways (PKP). The only suspicious part of his background was the fact that he somehow gained permission to study in Germany during the 1980s, a privilege that did not often come without agreeing to collaborate with the state intelligence services. But I found no information suggesting that he collaborated. Nor did I find any evidence of political connections playing a role in his business success.²⁵⁵

The final entrepreneur we will consider is Przemysław Sztuczowski. In the 1990s, he built the foundation for a future scrap-metal empire by driving around the country visiting contractors in his father's old Fiat. He used the profits to invest in steel

²⁵¹ "Mariusz Świtalski. Biznesmen Z Czerwoną Torebką," *Newsweek-Polska*, 2 November 2012; Sebastian Ogórek, "Mariusz Świtalski - Ojciec Chrzestny Polskiego Handle," *Wirtualna Polska*, 12 July 2013; Agnieszka Brzostek, "Niesamowita Kariera Mariusza Świtalskiego: Już Z Wyrokiem na Koncie Stworzył Żabkę i Biedronkę," *Gazeta Prawna*, 2 May 2013.

²⁵² Beata Drewnowska, "Polityk W Biznesie," *Rzeczpospolita*, 30 July 2009.

²⁵³ Maciej Rudke, "Kolarz W Butach," *Rzeczpospolita*, 8 November 2013; "Dariusz Miłek – Ludzie" <http://ludzie.pb.pl/dariusz-milek>.

²⁵⁴ "Kamprad Z Kalisza," *Forbes-Polska*, 10 March 2009.

²⁵⁵ Bartłomiej Mayer, "Powrót Chemika," *Rzeczpospolita* 16 September 2009; Agnieszka Stefańska, "Wielki Transportowiec," *Rzeczpospolita* 4 March 2008.

mills and foundries. "He owes his success to working hard and a bit of luck," according to one market analyst (the luck coming from skyrocketing metal prices in the 2000s).²⁵⁶

Stories like these – of individuals rising to great wealth at least in part through value-producing economic activity – are much more common among the Polish plutocratic elite than they are for the corresponding elites in Ukraine and Slovakia. The primary reason lays in the nature of the privatization process; the relative absence of opportunities to fraudulently privatize the biggest state companies cut off many political thugs from entering the plutocratic stratum and cleared the way for other kinds of businesspeople to fill its ranks.

The Failure of Property Rights Institutions in Poland

As the preceding sections have shown, raiding is equally common among Poland's non-plutocrats as it is in Slovakia and Ukraine but less widespread among the plutocratic elite. Does this warrant the conclusion that Poland's property rights institutions, at least at the plutocratic level, are more effective than those of Ukraine and Slovakia? While it is difficult to make a definitive judgment in this regard, simple logic suggests otherwise. If property rights institutions are not strong enough to limit non-plutocratic rapaciousness, how would they be strong enough to restrain the much wealthier and more influential plutocrats? To the extent that raiding is less frequent among the Polish plutocratic elite, this likely stems from other factors besides the strength of property rights institutions - in particular the lower presence of political thugs in this sphere. Moreover, the very fact that raiding is so frequent among the non-plutocrats implies that Poland's property rights institutions are not functioning as they should.

This section will further address the relative weakness of Poland's property rights institutions. While the evidence is anecdotal, taken together it does provide some indication of the severity of the problem. In certain respects Poland has developed reasonably effective institutions. Like Slovakia, it gets high marks for the transparency and availability of information on corporate ownership and judicial decisions.²⁵⁷ It is similarly regarded as having a well-functioning Financial Supervision Authority (formerly the Securities and Exchange Commission), which regulates capital markets. However, even this agency has failed to prevent or punish the self-dealing at many of the large, publicly-traded companies (such as Elektrim) described earlier. Similar financial regulatory agencies, such as the Pension Fund Supervisory Office (UNFE), have consistently abrogated their responsibilities. Indeed, Skarbiec (see above) was hardly an isolated example of fraud at major pension funds. When Ryszard Jach (the Skarbiec board member ousted by Kostrzewa) wrote a proposal for the adoption of new rules to prevent fund managers from self-dealing at the expense of shareholders, it was summarily rejected by UNFE and the major pension funds themselves. Following the 1999 pension reform, UNFE, which has ultimate oversight authority over the pension funds, has gone to great lengths to allow financial shenanigans by fund managers at the

²⁵⁶ Andrzej Krakowiak, "Stalowy Książę," *Rzeczpospolita*, 16 February 2008; Aleksandra Kozicka-Puch, "Jak Zbić Fortunę na Puskach po Piwie," *Onet.pl*, 14 March 2012.

²⁵⁷ The 2014 Arachnys Open Data Compass, *Arachnys Information Services Ltd*, ed. Arachnys Compass, <http://compass.arachnys.com/country/pl.html>.

expense of shareholders; it has refused to punish wrong-doing and rejected proposals to strengthen existing regulations.²⁵⁸

As some of the cases in this chapter demonstrate, the Polish higher courts have at times stepped in to reverse previous decisions that aided raiders in their attempts to expropriate others' assets. This distinguishes Poland from Ukraine, where I hardly found any such examples. But these interventions typically came many years later, well after the damage had already been done. And the actions of such honest judges evidently fail to act as a deterrent to raiding in general, as suggested by the very fact that raiding has remained so widespread. When it comes to the fundamental institutions of the state that are responsible for protecting property owners against expropriation - in particular its law enforcement, judicial, and tax-collecting agencies - this chapter has already presented ample evidence to suggest there is a problem.

In addition, while most of the right institutions, like civil service and anti-corruption laws, do exist, in practice they have proved insufficient to limit the worst abuses. Grzymała-Busse (2006: 154), who characterizes Poland as one of the post-communist leaders in institutional development, admits that the Polish civil service law, along with those in most other leading countries, "did more to limit hiring than to promote a meritocratic bureaucracy."

Conor O'Dwyer reaches the same conclusion; referring to Poland, Slovakia, and the Czech Republic, he concedes that "it is hard to discern the glimmerings of bureaucratization in any of these countries in terms of corruption;" in this respect, he believes, they still tend to approximate the former Soviet countries.²⁵⁹ At the Committee for European Integration and the related Ministry of Foreign Affairs, O'Dwyer saw a culture of "patronage and organizational disarray."²⁶⁰ As for the civil service code, O'Dwyer argues that it is regularly violated and circumvented by ruling parties who have still managed to engineer the appointment of their loyal designates in the state administration.²⁶¹ According to Jacek, who faced the attack described earlier on his business, Arcadium, there is little stability in state personnel in his province; after each change of power in Warsaw, for instance, a new Prosecutor-General is appointed who in turn replaces most of the regional and district prosecutors down the line.²⁶² This is far from the professional career stability that Max Weber highlighted as a hallmark of bureaucratic states.²⁶³

The highly-publicized attack on Roman Kluska from 2000 to 2002 spurred a number of institutional changes such as new restrictions on the state's discretion in auditing businesses. This is a power that had frequently been abused in attempts by raiders to paralyze their targets, as was the case with Arcadium.²⁶⁴ Nevertheless, as we have already seen, political thugs have proved more than able to continue their raiding activities since that time.

The reason for this, and for the weakness of property rights institutions in general, is the entrenched position of political thugs and crony capitalists in business and politics.

²⁵⁸ "The Open Pension Fund Market - One Year After the Debut," *Polish News Bulletin*, June 30, 2000.

²⁵⁹ O'Dwyer, *Runaway State-Building: Patronage Politics and Democratic Development*, 87.

²⁶⁰ *Ibid.*, 98.

²⁶¹ *Ibid.*, 196-97.

²⁶² Interview with Jacek.

²⁶³ Weber, *Economy and Society: An Outline of Interpretive Sociology*, 962-63.

²⁶⁴ Interview with Respondent #79.

Practically all of these individuals had roots in the old communist establishment. Collectively, they have worked to undermine the establishment of sound property rights. Zybortowicz describes an “undercover community” comprising current and former intelligence operatives as well as secret collaborators with the communist intelligence agencies. In his view, the members of this community systematically act to sabotage and subvert the rule of law.²⁶⁵ Writing of the East-Central European countries as a whole, including Poland, he echoes the conclusions drawn from the dozens of case studies in this chapter:

“Legally unregulated lobbying, myriad cases of conflict of interest, rampant corruption, limited efficiency of the police, and the Ministry of Justice are all both preconditions as well as results of the operation of such networks. One of the indicators of the...strength of these networks is the fact that myriad, ramified economic frauds on a large scale are rarely fully explained to the public, and usually the main culprits escape unpunished. Many of these frauds demanded complex logistical preparation and have taken place in companies or institutions which are under counterintelligence protection (either by civilian or by military services). Various figures connected both to [the] old and new services appear among the suspects in the largest of the frauds.”²⁶⁶

He concludes that the intelligence agencies “are not a guardian of the public good, of the public resources, of the rule of law. They have become an overactive agent of murky and ramified fights over [the] distribution [of] resources.”²⁶⁷

The dominant influence of this “undercover community” has led to a perverse inversion of the conventional state of affairs in countries that do feature the effective rule of law. In the latter societies, criminals in business and politics by and large remain marginalized while those in positions of power and wealth tend, on the whole, to be law-abiding. But in Poland, as in Ukraine and Slovakia, the opposite situation prevails. White collar criminals - and worse - who would normally find themselves imprisoned in places like Germany or Finland instead rule supreme in the top echelons of government and on and on the boards of the largest corporations.

The travails of one of my respondents provides a sad illustration of this phenomenon.²⁶⁸ He once served on the supervisory board of one of Poland’s top construction companies. He began asking uncomfortable questions regarding unexplained losses the firm had suffered in the course of a major project. Although he expected some resistance from the majority shareholder, which was responsible for the fraud in the first place, he found that the “independent” board members ganged up on him as well. “The problem,” he says, “is that they were independent in name only, not in fact.

²⁶⁵ Andrzej Zybortowicz, "Transformation of the Polish Secret Services: From Authoritarian to Informal Power Networks," in *Workshop on Democratic and Parliamentary Oversight of Intelligence Services* (Geneva: Geneva Centre for the Democratic Control of Armed Forces, 2002); Zybortowicz, "Anti-Development Interest Groups (Preliminary Outline)."

²⁶⁶ Zybortowicz, "Transformation of the Polish Secret Services: From Authoritarian to Informal Power Networks," 10.

²⁶⁷ *Ibid.*, 11.

²⁶⁸ All quotes and references from the following discussion come from an interview with Respondent #80, unless otherwise noted.

They had very close relations with the members of the management board.” The management, in turn, consistently denied him access to basic information they were required by law to disclose and generally obstructed him every step of the way. “Due to these connections between the supervisory board members and the management board members, and due to the fact that [the majority shareholder] was not interested in discussing this issue in an open manner, they decided to oust me from the supervisory board as quickly as possible.”

The basic problem was that there were many of them and only one of him. Moreover, they had connections in the state intelligence agencies, which further bolstered their power and unaccountability. After Bronisław Wildstein publicized the list of former secret-service agents, my source found that they contained the names of many of his opponents on the supervisory board. “One of the members of the supervisory board was a very close friend of former President Kwaśniewski – one of his closest friends, as I read in Rzeczpospolita. I asked him during the final supervisory board meeting, ‘have you been an agent of the secret service?’ And he told me ‘Yes! I am proud of that!’ He practically gave me the finger!...They thought they could do whatever they wanted. And they were right!”

The same respondent describes a similar experience as a whistleblower at one of Poland’s largest banks and how most of these banks were established by former officers and agents of the communist secret services:

Unfortunately, I had the unpleasant opportunity of working for such a bank, knowing nothing about [the links to the communist intelligence agencies]. And there was a very unpleasant clash between me and the people from the top management of the bank, who did have such links as well as a completely different opinion about the rules, about ethics, and about the law. For them, power is the only thing to consider. Ethics and the rules of ethics – forget it. For them, it means nothing...If you give them any problems, they can easily prepare a situation in which only you will be guilty of any irregularities. If you take into account that they are very powerful, they have money, they have media, they have financial institutions, then you have a simple choice: you may start to work as a member of this so-called mafia, or you can say ‘no, I’m not going to do as you do,’ and sooner or later you will be labeled a dangerous guy. My situation was such that I became a dangerous guy for those who should be on the margin. People like me should be the heroes. Unfortunately, people like me are often on the margin. They [the former intelligence operatives] play the most important roles.

His honest approach to supervising the companies he served ended up getting him blacklisted from employment at top Polish corporations. At one point he was offered a prominent position at PGNiG, the state gas company, only for the offer to be rescinded once the powers-that-be at the firm found out about it. “If you are not able to get a job because you have too many powerful enemies, however competent you may be, we call this situation the ‘wolf ticket’ [*wilczy bilet*] I got the wolf ticket three times in the last eight years.” He was later hired at a major investment fund. Before it was slated to be sold, he managed to get an offer for the company that was 50 percent higher than the one

the board was ready to accept. For this striking act of professional competence, he was fired. “In a normal world I would be rewarded. In this case, due to the fact that they wanted to sell this company below the market price, they decided to dismiss me... In the last eight years I’ve spent more time jobless than I have with a job.”

The laws that exist on paper prove ineffective when up against such powerful members of Zybertowicz’s “undercover community.” “We have here in Poland a commercial code, the rules of ethics, which applies to supervisory board members. But it’s all a bunch of shit,” says the source. “If somebody wants to act dishonestly, he doesn’t have to take into account the commercial code. He does whatever he wants to do. He can violate the law, the commercial code, everything, in order to obtain money unofficially, in order to get a contract.”

The insidious presence of political thugs and crony capitalists inside the Polish establishment has allowed them to hobble the development of effective property rights institutions. Freedom House continues to lament the persisting ineffectiveness of state institutions charged with combatting corruption. Its protests come on the heels of recent reforms that were supposed to strengthen the existing institutional framework:

Poland has a well-developed network of institutions that deal with the problem of corruption. The Central Anticorruption Bureau (CBA), established in 2006, has been charged with both coordinative and investigative tasks. The Internal Security Agency (ABW), the Central Bureau of Investigations (CBS), and other police units and state prosecutors’ offices also participate in combating corruption. Nevertheless, the level of political corruption in the country is significant and has seen no notable improvement in recent years. Polish politicians continue to treat their positions as an opportunity to enrich themselves and advance private interests making politics a competition for finite resources, rather than a means of public service. This damages the functioning of public institutions and undermines citizens’ confidence in them.²⁶⁹

Indeed, the highly-publicized and controversial campaign by the PiS government (2005-07) to root out corruption in the political and business spheres had much bark but little bite. The CBA undertook a series of high-profile witch-hunts to burnish the anti-corruption credentials of PiS leaders Jarosław and Lech Kaczyński. Its most high-profile catch was a former Sports Minister who was arrested and eventually convicted on corruption charges. Former Economy Minister Wiesław Kaczmarek was also arrested but the charges against him were dismissed.²⁷⁰ The CBA proved unable to catch any of the truly big fish, namely prominent political thugs such as Solorz, Starak, and Kulczyk.

When I was in Poland in 2008, many of my respondents described how the PiS’ anti-corruption campaign had begun to bring about real changes in the behavior of politicians. Paweł Reszka, a journalist, summed up the new appraisal: “Now, the

²⁶⁹ Natalia Letki and Maciej A. Górecki, "Poland," in *Nations in Transit 2013: Authoritarian Aggression and the Pressures of Austerity*, ed. Sylvana Habdank-Kończakowska (Washington: Freedom House, 2013), 440. Available at <http://www.freedomhouse.org/report/nations-transit/2013/poland>.

²⁷⁰ “Polish ex-sports minister Lipiec jailed for corruption,” *BBC News Europe*, 17 April 2012.

atmosphere has totally changed. Parliamentary deputies are more afraid to accept bribes. They now think there is actually a chance they will get caught.”²⁷¹

Nevertheless, as the new Civic Platform government (elected in 2007) settled into place, things quickly returned to normal. Another investigative journalist, went so far as to call Civic Platform the most corrupt party in Polish history. “If Poland keeps going the way it’s going, in ten years we’ll be like Romania where there’s nothing left to steal.” Leaving aside the former Sports Minister, he can think of no high-ranking officials who have ever been convicted of corruption.²⁷² Nor can my respondents recall any convictions of prominent businesspeople for violating securities laws.²⁷³

As the dozens of raids described earlier make clear, the situation in local government is even worse, especially outside of Warsaw. Jacek described to me how a district police chief who was building a house shook down local contractors and suppliers to sell him materials at cheap prices. “He comes to you, and you produce wood, for example. And he wants you to order the wood for his house but says ‘look, I’m on a tight budget, I count every zloty.’ So what the businessman has to do is set the invoice at below cost. Typical. And then he goes to the gardener, the stone mason, the plumber, the electrician, pushing all of them for half-price. This is the method.” Such abuses are not restricted to the police; the local fire chief once demanded that Jacek hire his relative to a do-nothing position at Arcadium in exchange for avoiding safety inspections.

A coal trader in Silesia describes a similar experience. He was approached by a local official who “suggested” that his company use the services of another firm that happened to be connected to the local political establishment. The “services” in question consisted of protection from local authorities to be secured by the regular payment of a fee for every ton of coal that passed through the company. The businessman refused and the enterprise was duly audited. Simultaneously, a number of his trading partners suddenly backed out their agreements. “I quit the business because it started to become too threatening,” he says.²⁷⁴

“The networks that are undermining state authority in central and southern Poland are particularly damaging to honest businesses,” according to one report from 2008. “Local notables regularly fraternize with police officers, members of the legal professions, and businessmen, and often with gangsters. This has a huge psychological impact – people see that and let themselves be manipulated because they know they’ll never beat the network.”²⁷⁵

Shleifer and Vishny attribute Poland’s supposedly superior property-rights regime, as compared with Russia, to the institutional design of local government. In particular, they point to the fact that local officials in Poland are elected rather than appointed and are responsible for raising revenue on their own to finance public services.²⁷⁶ The evidence unearthed in this study suggests that the alleged differences in this regard between the two countries are, if anything, much overdrawn; in case after case we have seen how regional and local officials acted with impunity to destroy businesses.

²⁷¹ Interview with Paweł Reszka; Interview with Grażyna Kopińska.

²⁷² Interviews with Respondent #89, 2008 and 2013.

²⁷³ Interview with Respondent #80.

²⁷⁴ Rafał Pasztelański, “Kto zabija państwo,” *Wprost*, No. 16/2008 (<http://www.wprost.pl/ar/127632/Kto-zabija-panstwo/>).

²⁷⁵ Ibid.

²⁷⁶ Shleifer and Vishny, chapter 11.

When it comes to the sanctity of property rights, it is largely irrelevant whether the scale of overall corruption in Poland is higher or lower than in Ukraine or Slovakia. What matters most is whether would-be raiders with the proper political connections can use these relationships when they need to. In that respect, the multitude of case studies in this chapter suggests there is little difference indeed among the three countries.

Even simple reforms such as efforts to expand public access to official information - let alone fundamental changes in the relationship between the state and private property - encounter fierce opposition from the ruling establishment. Following a haranguing by the European Commission, the *Sejm*, Poland's lower house of parliament, adopted a bill in 2011 aimed at harmonizing Polish legislation on public information access with that of the EU. Immediately, NGOs and members of the opposition complained about a vague provision in the draft law allowing state agencies to make an exception when "important state interests" were at stake. In response to the resulting uproar, the provision was removed. But soon thereafter, Marek Rocki, a member of the ruling Civic Platform party in the Senate (the upper house), reinserted it. In doing so he violated the customary procedure whereby the Senate is not supposed to substantially change legislation that has already been passed by the *Sejm*. The Constitutional Tribunal ruled in April 2012 that the amendment was unconstitutional, but Paweł Olszewski, an influential member of Civic Platform, has nevertheless declared that the party will in the future seek to reinstitute limitations on public access to information.²⁷⁷

If the adoption of more effective laws and regulations often proves difficult, that of complex and burdensome ones does not. After all, the latter, unlike the former, increase rather than constrain opportunities for corruption and patronage. In the 1990s, business regulation tended to be far simpler than it is today, as is evident from surveys conducted at the time.²⁷⁸ But a recent World Bank study that ranked Poland 151st out of 183 countries in the ease of doing business is just one among scores of similar studies that have reached similar findings.²⁷⁹ "Presumably to keep certain folk in employment," *The Economist* wrote in 2012, "notary acts still require binding with specially coloured string, and an imprint from a special stamp, in special purple ink. Each piece of freelance work requires a written contract. Foreign investors, drawn in by good-news stories about the Polish economy, alternately laugh and weep when they discover what hoops they have to jump through to conduct business here." Indeed, since coming to power in 2007, the Civic Platform government has added at least 150,000 new bureaucratic positions - an increase of 13.8 percent in the total number of bureaucrats. The idea, of course, is to dole out jobs to supporters.²⁸⁰

"Can you imagine," Jacek complained, "that when I used to live in Warsaw at the beginning of the 90s, when the tax code wasn't so complicated, the tax office in my district occupied one floor of a building?. Today there are four floors and they are still trying to get more space." As the number of officials has ballooned in size, so has the tax code in complexity. "At the beginning of the 1990s I had to fill out a one-page tax form.

²⁷⁷ Letki and Górecki, 430-31.

²⁷⁸ Frye and Shleifer, "The Invisible Hand and the Grabbing Hand."

²⁷⁹ "Horse Power to Horsepower," *The Economist*, 28 January 2010 (<http://www.economist.com/node/15394158>).

²⁸⁰ "The Vogans of the east," *The Economist*, 26 April 2012.

Now, I personally have to fill out five pages and the company another five pages. It's just so complicated."²⁸¹

According to Jacek, the SLD government that came to power in 2001 greatly expanded the leeway of prosecutors and regulators to punish business owners suspected of wrongdoing. These rules along with others have enabled raiders and the officials, auditors, and inspectors who do their bidding to destroy or nearly destroy scores of businesses, as we have already seen. To be sure, one cannot attribute the entire system of burdensome bureaucracy to a conspiracy of predators at the top. Nevertheless, the fact that such little effort has been undertaken to reform it may indeed reflect the willful intention of the establishment and particularly the political thugs and crony capitalists who have a vested interest in keeping things the way they are.

An Austrian investor who purchased a prime piece of real estate in central Warsaw discovered just how arbitrary the system can be. After consulting lawyers, transferring the money to the seller, and getting the transaction notarized, he was informed by the Interior Ministry that the sale was null and void. The reason? He had not obtained official permission from the ministry to buy the property which, the ministry claimed, all foreigners are required to do. This was despite the fact that the law clearly exempts EU citizens from this requirement. Two law firms, the notary who handled the transaction, and the Official Board of Notaries all backed up the Austrian investor on this point. The Interior Ministry nevertheless continued to insist that he broke the law and subsequently issued an ultimatum: he could either remain on the property and face a potentially crippling lawsuit or transfer the land back to the seller and formally apply for the official permit that he is not required to obtain in the first place. Not surprisingly, he chose the latter option. As of the time I spoke to him, however, he had still not received his land.²⁸²

The ultimate recourse for those who suffer such egregious violations of their property rights is the courts. In Poland, the courts have indeed ruled in favor of many individuals who endured the unlawful persecution of state authorities. At the same time, the Polish courts - particularly at the first-instance level - have aided and abetted many of the raids discussed in this chapter. If and when restitution arrives, it is, almost without exception, too little, too late. To this day, the judicial system remains notorious for its corruption and delays as well as the incompetence of its officials. This is especially true in the civil courts but is a serious problem in the criminal courts as well. While this is partly due to understaffing, it also reflects the interests of the most influential business and political actors; put simply, it pays to have a system in which low-paid judges and prosecutors are easily corrupted, court chairmen have discretion in the assignment of cases to judges, impossible delays in civil proceedings privilege those who can grease the wheels of justice, and slow criminal cases prolong the amount of time takeover targets can be locked away in pretrial detention. Poland is not a poor country; it can arguably afford the costs associated with reforming the judicial system. So why do recent reports identify precisely the same problems in the system that were noted in the highly-

²⁸¹ Interview with Jacek

²⁸² Interview with Respondent #88.

publicized World Bank investigation of 1999?²⁸³ Polish citizens might be forgiven for thinking that the powers-that-be are keeping things this way deliberately.

Indeed, old-boy communist networks continue to plague Poland's judicial system. Teresa Romer, a retired judge renowned for her heroic defiance of party authorities under communism, laments that, with the exception of the Supreme Court, judges were not forced to resign and reapply for their positions after 1989. "They decided not to undertake a complete reappointment of judges after the transition. Maybe it was a mistake. I am now more convinced that it was a mistake." Although she believes that corruption in the courts is not as endemic as some reports claim, she "cannot deny, even to myself, that there are judges who are corrupt and are still judges."²⁸⁴

A scandal surrounding the collapse of a financial pyramid scheme in 2012 spurred an explosion of public anger over the collusion of judges and prosecutors with their political and business allies. Amber Gold, the company that ran the scheme in question, was set up in 2009 by a young businessman with multiple prior convictions for fraud. Offering investors unrealistically high returns, the fund attracted the scrutiny of the National Financial Audit Committee, which alerted multiple state agencies of the potential damage. These included the Prosecutor-General's Office and the Anti-Monopoly and Consumer Protection Office. Despite the repeated warnings, however, none of these bodies took any action. Amber Gold did not even face any penalties from the Tax Office for failing to file its annual reports.²⁸⁵

When the fund inevitably collapsed, its clients lost nearly \$90 million in savings and its managers were put on trial. Amidst the public uproar that ensued, a journalist posing as a representative of the Prime Minister phoned the court chairman overseeing the case and recorded the call. The recording reveals the judge asking the journalist for instructions on how to rule in the case and even requesting a meeting with the Prime Minister to discuss the issue. The judge's miscalculation was less a matter of gullibility than a realistic assessment of how the system works. Indeed, the Civic Platform coalition fueled speculation of its unlawful interference in the case when it refused calls to create a special parliamentary committee to investigate allegations of collusion between the party and Amber Gold.²⁸⁶

As in Ukraine and Slovakia, Poland can be a dangerous place for official investigators who pry into corruption. In one instance, an auditor from PWC, the international accounting firm, was drugged and left to die in his hotel room. The scene was staged to make it appear as if he overdosed on drugs while cavorting with prostitutes.²⁸⁷ In another case, the deputy director of a bank was physically threatened not to reveal information about loans that had been handed out to cronies and not repaid.²⁸⁸ In addition, as the fate of some of the FOZZ investigators along with Marek Karp showed, "accidents" seem to happen with greater frequency to those who threaten the status quo than they do to the general population.

²⁸³ Krzysztof Jasiewicz, "Poland," in *Nations in Transit 2011: The Authoritarian Dead End in the Former Soviet Union*, ed. Christopher Walker (Washington: Freedom House, 2011); The World Bank, *Corruption in Poland: Review of Priority Areas and Proposals for Action* (Warsaw: The World Bank, 1999).

²⁸⁴ Interview with Teresa Romer.

²⁸⁵ Letki and Górecki, 439.

²⁸⁶ Ibid.

²⁸⁷ Interview with source.

²⁸⁸ Interview with Respondent #73.

All of this underscores the way influential political thugs, crony capitalists, and their bidders in the Polish political establishment have acted time and again to manipulate, evade, and otherwise sabotage the means of effectively enforcing legal property rights. When the system is so heavily dominated by economic predators, efforts to change one law or another are not going to solve the problem. The task at hand is instead to weaken the predators themselves. Undermine the actors with an interest in keeping property rights institutions weak and attempts to build such institutions will meet with far greater success.

There seems to be a consensus among international organizations and specialists that the cure for Poland's ills rests in better laws, rules, and procedures. Freedom House and Transparency International, for instance, have repeatedly called for such changes as one-mandate election precincts, improved definitions of conflicts of interest, enhanced anti-corruption laws, and "an increase in the transparency of administration and public institutions through the full implementation of the 2001 Law on Freedom of Information."²⁸⁹ The fact that this 2001 has still not been fully implemented should suggest by itself the pressing imperative to weaken the powerful interest groups responsible for such delays rather than prioritizing improvements in law-enforcement.

Conclusion

The mass of case study evidence presented in this chapter calls into question the notion that post-communist Poland has developed even reasonably sound property rights institutions. They demonstrate that, particularly among the non-plutocratic elite, political thugs can run roughshod over other businesses by freely exploiting their privileged access to the state's agents of force. The formal rules of the game are evidently unable to contain the collective power of dense networks linking political thugs to party leaders (especially on the left), former secret agents, current and former intelligence officers, police, prosecutors, judges, and other state officials. What emerges is a picture of a society in which conspiracies are not simply the imagined concoctions of paranoid recluses; in Poland, they really do exist.

That said, the incidence of raiding among the ultra-wealthy plutocrats is considerably lower than in Ukraine and Slovakia. This is a result of the lesser degree of corruption in the privatization of the biggest state companies, itself the outcome of robust party competition.

If outright fraud was rarely possible in the privatization process, an abundant array of other soft budget constraints were indeed available to those with the necessary political connections. They ranged from sweetheart deals with public and quasi-public agencies like the CHZs and ZUS, soft loans from the FOZZ and state-owned banks, self-dealing at PZU, and corrupt flows of state funds in the energy sector. Soft budget constraints such as these enabled a new class of political thugs, especially among the non-plutocratic elite, to metastasize over the political and business realms and especially the non-plutocratic elite. They also propelled several political thugs into the plutocratic

²⁸⁹ "Poland," in *Nations in Transit 2007: Pause and Pushback for Democratization*, ed. Freedom House (Washington: Freedom House, 2007). Available at <http://www.freedomhouse.org/report/nations-transit/2007/poland>.

elite. Scores of these individuals have been implicated in criminal corporate raiding, as we have seen.

The current tendency among social scientists would be to recommend broad institutional reforms, such as enhancing transparency, simplifying economic regulations and taxation, and trying to clean up the judiciary. The evidence from this and other chapters suggests that efforts like these would come to naught as powerful criminal networks forestall or adapt any new rules to maintain their privileged positions. Instead of hoping that institutional changes will bring these actors into line, the country would be better served by efforts to fundamentally attack the very foundations of their criminal wealth.

Many of the soft budget constraints that played a prominent role in this chapter, from the CHZs and the FOZZ to systemic fraud in the banking system, have largely disappeared from the scene and are no longer available. Nevertheless, the damage they wrought remains to this day in the form of the political thugs and crony capitalists they spawned. If efforts to develop effective property rights institutions are to succeed – or even be undertaken at all – the predatory business actors who wield such immense influence over the political system must be fundamentally weakened. Achieving this will obviously prove difficult. At a minimum, it requires the rise of a committed, reformist government that ends the provision of those soft budget constraints that continue to line their pockets – namely corrupt state contracts as well as fraudulent privatizations, which have become more frequent under Civic Platform. Even greater progress would obtain from the retroactive taxation of the massive rents that have built up and sustained the parasitical class. Targeted efforts like these to weaken political thugs and crony capitalists will be far more effective than attempts to improve the design and enforcement of prevailing institutions; such changes will likely fall victim to manipulation and evasion by predatory elites as they repeatedly have done in the past. Undermine the interest groups bent on preserving the status quo and real institutional change may indeed become possible.

“You must make a choice: Do you want to be a popular government, or do you want to do what has to be done?”

—Mart Laar¹

Chapter Seven

Draining the Criminal Swamp: Hard Budget Constraints and Property Rights Institutions in Estonia

The market transformation in Estonia is widely regarded to have been among the swiftest and most radical in the former Eastern bloc. The reforms began under the transitional government of Tiit Vähi, appointed in January 1992, and attained new heights after the election of Mart Laar’s Pro Patria party in October of that year. The two governments undertook rapid internal and external liberalization, monetary reform, privatization, and various institutional reforms.² The key development for our purposes was the Pro Patria government’s comprehensive program of hard budget constraints. In this regard, the divergence from Poland and Slovakia (not to mention Ukraine) was dramatic indeed.

The Estonian case helps answer the central question of this dissertation: under what conditions can a new government irreversibly marginalize the economic predators who will otherwise sabotage effective property rights institutions? The answer is the sweeping implementation of hard budget constraints. This study assumes that would-be political thugs are distributed evenly among the human population regardless of political or cultural boundaries. Presumably, Estonian society is no different from any other in terms of the percentage of individuals with the inclination to use force in pursuit of profits. What distinguished Estonia was the implementation of hard budget constraints, which limited the ability of such people to make it into the economic elite. As we will see, corrupt business actors are hardly absent in Estonia. But their relative share of the elite is substantially lower than in the other three countries. Where they did acquire significant wealth, it was due to “leaks” in the general policy of hard budget constraints whereby state funds and other assets happened to end up in the hands of the politically-connected. For the most part, these leaks emerged only under later governments.

In this way, the political thugs and crony capitalists that do populate the Estonian elite are the exceptions that prove the rule: hard budgets are the best hope for fatally

¹ Margaret Shapiro, “Estonia hums after rebirth of freedom,” *Washington Post*, 21 June 1993.

² Ole Nørgaard and Lars Johannsen, *The Baltic States after Independence* (Cheltenham, UK: Edward Elgar, 1999), 133-35.

Table 7.1. Estonia's Plutocratic Elite

<u>Name</u>	<u>Alleged Type</u>	<u>Raiding?</u>
Raul Kirjanen	?	
Toomas Tamm	?	
Enn Pant	CC	?
Rein Kilk	CC	
Alar Tamming	CC	
Toomas Annus	CC	
Urmas Sõõrumaa	CC	
Margus Linnamäe	CC	
Vello Kunman	CC or E	
Heldur Meerits	CC or E	
Joakim Johan Helenius	E	
Kaido Jõelet	E	
Margus Reinsalu	E	
Väino Kaldoja	E	
Armin Karu	E	
Feodor Berman	E	
Hillar Teder	E	
Igor Izraeljan	E	
Jaan Korpusov	E	
Mati Polli	E	
Mihhail Gnidin	E	
Peeter Mänd	E	
Peter Hunt	E	
Sonny Aswani	E	
Tiit Aava	E	
Valeri Kovalenko	E	
Viktor Levada	E	
Hans Luik	E	
Toonart Rääsk	PT*	
Marcel Vichmann	PT*	
Ain Hanschmidt	PT	X
Anatoli Kanajev	PT	
Kalev Järvelill	PT	?
Oleg Ossinovski	PT	X
Elar Sarapuu	PT	
Margus Kangro	PT	
Priit Piilmann	PT	
Ants Laos	PT	

<u>Raiders</u>	<u>% of Pluto Elite</u>
Raiders	5.3% to 10.5%
Possible Raiders	n/a
<u>Actor-Types</u>	
E	47.4%
E or CC	5.3%
CC	15.8%
CC or PT	n/a
PT	26.3%
Entrepreneurs	47.4% to 57.9%
Crony Capitalists	15.8% to 26.3%
Political Thugs	26.3 % to 31.6%
CC & PT Combined	42.1% to 52.6%

Key

CC = Crony Capitalist

E = Entrepreneur

PT = Political Thug

**Denotes considerable uncertainty over proper classification as political thugs, although they do not fit into any other category*

undermining criminally-inclined business actors. With a few key lapses, the country's policymakers implemented them to great effect. The speed with which the Laar government carried out its policy of hard budget constraints proved essential; it was voted out of power after only two years in office. Thanks to its efforts, would-be political thugs and crony capitalists, to a far greater extent than in the other three countries, found themselves cut off from state largesse. This prevented them from achieving anywhere near the wealth and influence their counterparts attained in Poland, Slovakia, and Ukraine. Taken together, political thugs and crony capitalists make up 42 to 53 percent of the plutocratic elite. At first glance, this might seem substantial. But the corresponding figures for Poland (56-69 percent) and particularly Slovakia (77 to 88 percent) and Ukraine (83 to 98 percent) bring the Estonian situation into sharp relief. Political thugs alone comprise only 26 to 32 percent of Estonia's plutocrats, compared to 53 to 65 percent in Ukraine and 71 to 77 percent in Slovakia. Moreover, the maximum figure for Estonia – 53 percent – assumes the two plutocrats for whom I was not able to find any relevant information are in fact political thugs or crony capitalists; they may very well be entrepreneurs instead, which would bring the maximum percentage of combined political thugs and crony capitalists down to 47 percent – a minority of the plutocratic elite. Table 7.1 provides a breakdown of Estonia's plutocratic elite according to actor-type and alleged associations with raiding. A comparison of all four countries can be found in Table 3.5.

For the non-plutocratic elite, it is far more difficult to arrive at specific numbers. However, political thugs and crony capitalists were certainly much harder to find in Estonia than in the three other countries. In the course of my research, the same individuals kept coming up again and again. This is quite different from Poland, Slovakia, and Ukraine where, with the slightest scratch of the surface, I was able to uncover an ever-increasing number of political thugs and crony capitalists. The lower presence of political thugs, in particular, is further evidenced by the fact that I found far fewer criminal corporate raids committed by non-plutocrats. If there really were large numbers of political thugs in the business world, one would expect to observe a much higher incidence of raiding – especially during the 1990s when Estonia's property rights institutions had barely gotten off the ground. Even then, however, raiding was rare. Given the severe institutional flux at the time, it is logical to conclude that the lack of raids resulted not from the institutional robustness of the state but rather from the relative absence of the economic criminals likely to initiate them.

While hard budget constraints were instrumental in marginalizing corrupt businesspeople, this does not mean that Estonia's leaders had this particular outcome in mind when they were carrying out the policy. Other considerations dominated their thinking at the time – namely the need to minimize government deficits and create the competitive economic conditions necessary for a market to function. Whatever their reasons, however, they did adopt a program of hard budget constraints. The consequences would prove far-reaching.

One result of hard budgets and the subsequent paucity of political thugs was a far lesser incidence of criminal corporate raiding - both among the plutocratic and non-plutocratic elites. Like Poland, Estonia displays relatively little raiding in the plutocratic sphere; only 5 to 11 percent of plutocrats have been linked to raiding (in Poland the corresponding figure is 13 to 15 percent). This compares to 47 percent in Slovakia and

Table 7.2. Alleged Non-Plutocratic Raids

Raid #	Target	Sector	Alleged Perpetrator	Pol. Thug?
1	La Ferme	7	Imre Arakas et al	Yes
2	Flora Vara	4	Flora shareholders	No
3	Agrolinda	7	Arakas, Veike, Jõgi, Kajar et al.	Yes
4	Vasara	7	Arakas	Yes
Percent who are political thugs				75.0%

Sector Key

Sector #	Sector Name	Raid?
1	Agriculture, forestry and fishing (ISIS Rev. 4 Sec. A)	
2	Manufacturing, mining and quarrying and other industry (B, C, D, E)	
3	Construction (F)	
4	Wholesale and retail trade, transportation and storage, accommodation and food service activities (G, H, I)	X
5	Information and communication (J)	
6	Financial and insurance activities (K)	
7	Real estate activities (L)	X
8	Professional, scientific, technical, administration and support service activities (M, N)	
9	Other services (R, S, T, U)	

35 to 45 percent in Ukraine. Unlike Poland, raiding is exceedingly rare in the non-plutocratic stratum as well; I found definite raids in only two of nine economic sectors in Estonia as compared to seven in Poland (Table 7.2).

While illegal asset transfers are hardly unknown in Estonia, they fundamentally differ in character from those common to the other three countries. In particular, they hardly ever involve the connivance of an agent of force, a necessary condition to qualify them as raids. With few exceptions, Estonian state officials cannot be recruited to assist in such takeovers. The fact that would-be raiders must make their way in the world without state support considerably impedes their activities and renders other business actors much safer from the threat of expropriation.

Aside from limiting raiding, the relative deficit of political thugs and crony capitalists actually made it feasible to establish sound property rights institutions. Indeed, Estonia shows just how useful it is to treat institutions as effects of actor behavior and not just as causes. The simple reason is that, in Estonia, to a far greater extent than in the rest of the post-communist region, the institutions did not even exist at the outset of the reforms. During the Soviet period, most affairs of the tiny colonial outpost were run

directly from Moscow. This created the need for entire institutional domains to be created from scratch once independence was secured. The other three countries - especially Poland and Slovakia - at least had independent institutional precursors stretching back into the communist era and beyond. But Estonia lacked even such basic institutional trappings as its own police, border guard, currency, tax-collection system, or even a state budget. Until the late 1990s, it endured a period of severe institutional flux with huge areas of market-related law - not to mention the capacity to enforce these laws - entirely absent. A condition of institutional instability is characteristic of most early-capitalist societies. But in Estonia it was especially pronounced. This would have provided fertile ground for political thugs and crony capitalists to emerge predominant. But a stringent policy of hard budget constraints averted this outcome. It did so precisely by sucking the wind from beneath the sorts of actors who might otherwise have brought the new institutions under their thumbs.

Without powerful networks of economic criminals seeking to corrupt state actors, effective rules could be adopted and implemented with minimal interference. Especially in the 1990s, when civil servants were vulnerable to corruption because of low pay, this gave Estonia's new property rights institutions sufficient room to develop. In Poland, Slovakia, and Ukraine, we were able to observe perverse feedback loops between soft budget constraints, the rise of economic criminals, and the weakness of institutions. In Estonia, the feedback effects would operate in reverse. What emerged as a result was a continual process of building, simplifying, and improving state institutions to the detriment of corrupt business actors.

Estonia shows the virtues of competition in aiding the establishment of sound property rights institutions. Not only did competition-inducing hard budget constraints play a deciding role; robust competition among political parties had the effect of limiting one particularly important soft budget constraint: the fraudulent privatization of state companies. The Estonian case likewise demonstrates that governments can subject firms to hard budget constraints regardless of whether they are privately-owned or state-owned; privatization is evidently not a precondition for hard budgets, contrary to what some specialists have suggested.³

Finally, this study argues that social scientists must expand their view of the connection between actors and institutions, looking not only at the ways institutions affect actors but also at how actors shape institutions. In Estonia, we will see both of these processes at work; institutions in the form of hard budget constraints helped to sideline political thugs and crony capitalists while the relative absence of these actors enabled strong property rights institutions to take root.

This chapter will begin by detailing the implementation of hard budget constraints in the 1990s along with its consequences for the character of the business elite. It will then survey the few criminal corporate raids that did occur among the non-plutocratic elite as well as the lesser forms of asset-stripping that have tended to surface. After this we will survey the plutocratic elite; while a number of political thugs - or something approximating political thugs - do operate, they as well as crony capitalists do not have nearly as much of a presence as in the other three countries. The final sections will turn to the emergence, from virtually nothing, of a set of robust, market-supporting property rights institutions.

³ Schmidt, "The Costs and Benefits of Privatization: An Incomplete Contracts Approach."

Hard Budget Constraints and the Estonian Transformation

Like Slovakia, the anti-communist opposition in Estonia took power through the wholesale replacement of the communist regime. No formal negotiations with the ruling communists marked the transition.

The process began with the first fully-free parliamentary elections, held in 1990 while Estonia was still a constituent part of the Soviet Union. The largest faction in the newly-elected Supreme Soviet was the Popular Front of Estonia (PFE) led by Edgar Savisaar. The PFE was in fact a loose alliance of factions with diverse interests that would eventually disintegrate following the collapse of the Soviet Union. It was composed not only of anti-communist radicals but also reform-minded ex-communists; 13 out of 23 ministers in Savisaar's government were former party members (although none except Savisaar belonged to the nomenklatura).⁴

While divisions existed within the PFE, virtually all of its affiliated members were, in one important respect, fully committed to a singular ideology. This ideology linked the imperative of national sovereignty with the twin tasks of regime change and radical, market-oriented economic transformation. Moreover, it perceived these imperatives as mutually-interdependent, systemic, and urgent in nature. To this extent, the ideology was not only nationalist but revolutionary as well. The combination of the two elements can be seen in the following statement by Savisaar:

Only economic successes will make us free, and freedom in itself does not resolve a single economic or ecological problem. There are quite a lot of formally independent states in which any economic sneeze by neighbors at once rebounds upon customs policy, principles of immigration, and so forth. At the same time there are dependent states which are essentially sovereign. Sovereignty means the right to adopt the final decision, and independence in the form of their own statehood means just the inviolability of their borders...Power belongs not to jurisprudence but to the economy and well organized relations both in one's own society and with neighboring states. No law will work unless it is backed up materially....Unsubstantiated formal juridical theses on our rights will not get things moving on their own.⁵

This sense of the interdependent nature of Estonia's problems was widely shared among the elites that assumed power in 1990. The PFE gained a much greater portion of the seats in the 1990 parliament than similar movements in the other non-Baltic republics. At the same time, it did not win a majority, capturing only 42 of 105 spots. But it did constitute the largest faction in the Supreme Soviet and succeeded in getting Savisaar appointed Supreme Soviet Chairman, which would become the most important position in the republic. Meanwhile, reflecting the enormous amount of popular alienation from

⁴ Anton Steen and Juri Ruus, "Change of Regime – Continuity of Elites? The Case of Estonia," *East European Politics and Societies* 16, no. 1 (2002): 236-37.

⁵ "People's Front Chairman Interviewed," *Foreign Broadcast Information Service/Soviet Union*, 14 August 1989.

the existing system, only five parliamentary deputies were high-level members of the nomenklatura.⁶

After the breakup of the USSR, a transitional government was appointed under Tiit Vähi. Like its predecessor, a majority its officials were former party members.⁷ It would instead be the coalition led by Mart Laar, elected in September 1992, that would initiate the real “house cleaning” of the government. In these elections, the reform-communist Left Opportunity failed to make it past the five-percent threshold. In addition, only 35 percent of the deputies in the 1992 parliament had previously belonged to the communist party. Substantially fewer were members of the former nomenklatura. Furthermore, the coalition government formed by Laar’s Pro Patria Party (*Isamaaliit*), the Estonian National Independence Party, and the Moderates included only one minister with a background in the communist party.⁸

Thus, by the autumn of its first full year of independence, the Estonian government was under the full control of a revolutionary counter-elite. This counter-elite was committed to an ideology that viewed as mutually interdependent the imperatives of national sovereignty, regime change, and radical economic transformation.

Thanks to the personnel policies of Laar and his colleagues, the nomenklatura’s fall from grace extended down to the lowest reaches of the state administration. By 1994, 49 percent of civil servants were still former communist party members (a figure that would rise to 59 percent by 1997). The vast majority of prosecutors, judges, and municipal officials were also former communists. However, the situation was quite different for the one-time nomenklatura, whose members constituted only 12 percent of all civil servants by 1996, down from 46 percent in 1986.⁹

According to Aavo Kokk, who served in official roles during the transition years, the election of Pro Patria brought sweeping changes to local government; its leaders, he says, were “very determined in implementing their economic approach. This took most of the reforms to the local level both in municipalities and in different central agencies. Before that it depended a bit on the particular people in charge, and it was very erratic. So in one place it could be very different than in another place. When the new *Isamaa* people were put in charge, they of course appointed new mayors, directors, etc., and these tended to be very young people. And they just pushed for change.”¹⁰ Meanwhile, much of the rest of the bureaucracy had to be created from scratch, with new personnel hired, even before communism ended. This development will be described in detail in a later section.

Thus, while younger and lower-ranking ex-communists often did rise to higher level positions in the 1990s, the nomenklatura did not survive either in government or the state.¹¹ However, Slovakia too witnessed the comprehensive replacement of the former nomenklatura. Just as in Estonia, a draconian lustration law was enacted in 1991 that barred former high-ranking officials along with officers and agents of the communist intelligence agencies from a range of positions in government, the bureaucracy,

⁶ Sources of this information on the 1990 and 1992 election results are Steen and Ruus, "Change of Regime – Continuity of Elites? The Case of Estonia."; Kionka.

⁷ Steen and Ruus, "Change of Regime – Continuity of Elites? The Case of Estonia," 237.

⁸ Sources of this information on the 1990 and 1992 election results are *ibid.*; Kionka.

⁹ Steen and Ruus, "Change of Regime – Continuity of Elites? The Case of Estonia," 239-45.

¹⁰ Interview with Aavo Kokk.

¹¹ Steen and Ruus, "Change of Regime – Continuity of Elites? The Case of Estonia," 239-45.

academia, and the media.¹² Nevertheless, political thugs from the communist establishment managed to stage a comeback by helping to bring the HZDS to power.

In Estonia, nothing of the sort would occur. And yet, in the early 1990s, a potential basis for Slovak-style political capitalism was already in place. The transitional Vähi government, in power for much of 1992, was marred by “accusations that corruption and spontaneous privatization flourished among his friends from the Soviet period, who were also from the ranks of state managers.”¹³ After leaving office later that year, Vähi would return as Prime Minister a second time following the 1995 elections. Once again, a majority of the ministers he appointed were former communist party members.¹⁴ However, there would be few signs that corrupt business actors had nearly the kind of influence enjoyed by their Slovak counterparts under Mečiar .

What accounts for these divergent outcomes? How is it that Estonia’s early post-communist governments laid the foundation for the permanent marginalization of political thugs and crony capitalists whereas Slovakia’s governments failed to do the same? The answer is simple: the radical program of hard budget constraints carried out by the Laar government in Estonia cut off the emerging class of political thugs at the knees. In Czechoslovakia (and, later, Slovakia), persisting soft budget constraints enabled such actors to survive through the early 1990s and return with a vengeance under the HZDS. In Estonia, this would not be the case.

It is difficult to identify clear structural factors that explain why Estonia’s leaders imposed hard budget constraints to such an extent while their Czech and Slovak counterparts did not. It is possible that a legacy of bureaucratic rectitude in Estonia left a cultural imprint that militated against the unrestrained provision of state resources to government cronies. But that constitutes a long and tenuous chain of historical causation and, as we will see, experts are far from agreed on whether that supposed legacy of honest government actually existed at all. Why did the Klaus government in the Czech Republic remain so obsessed with its program of rapid privatization to the detriment of reining in soft budget constraints in the financial system while the Laar government did not fall into this trap? The reasons must at least partially come down to the particular ideological beliefs, priorities, and commitment of Laar and his colleagues.

The technocrats appointed by Laar were hardly aware of the full implications their commitment to hard budget constraints would entail. For them, a market economy required firms that could survive without state support and this made hard budget constraints a necessary component of market reforms. It is highly unlikely that they explicitly intended to use these policies to sideline corrupt business actors that might otherwise sabotage the development of sound property rights. But regardless of its intentions, the new government did harden budget constraints and did so with the staunch support of Prime Minister Laar himself: “You must make a choice: Do you want to be a

¹² Mark Ellis, "Purging the Past: The Current State of Lustration Laws in the Former Communist Bloc," *Law and Contemporary Problems* 59, no. 4 (1996); Lavinia Stan, "Conclusion: Explaining Country Differences," in *Transitional Justice in Eastern Europe and the Former Soviet Union: Reckoning with the Communist Past*, ed. Lavinia Stan (Abingdon, Oxon, UK and New York: Routledge, 2009). In Estonia, lustration was achieved mainly through provisions of the Citizenship Law and has met with accusations of unfairly targeting Russian-speakers.

¹³ Steen and Ruus, "Change of Regime – Continuity of Elites? The Case of Estonia," 237.

¹⁴ *Ibid.*, 237 (Table 1).

Table 7.3: The Degree and Speed with which Hard Budget Constraints were Instituted (1-2 years into transition)

	<u>Enterprise Restructuring</u>	<u>Price liberalization</u>	<u>Banking Reform</u>	<u>Average</u>	<u>% Difference from Estonia</u>
Estonia (1993)	3.00	4.33	3.00	3.44	
Poland (1991)	2.00	3.67	2.00	2.56	-26.6%
Slovakia (1991)	2.00	4.00	2.00	2.67	-23.3%
Ukraine (1993)	1.00	1.00	1.00	1.00	-73.4%

Source: EBRD Transition Indicators
(<http://www.ebrd.com/pages/research/economics/data/macro.shtml>)

popular government, or do you want to do what has to be done?” he asked, as if no other option was even available.¹⁵

The coalition moved swiftly in this direction (Tables 7.3 and 7.4). A previous chapter showed how the first Slovak governments did not close down insolvent state banks, choosing instead to carve out the non-performing loans (NPLs) from their balance sheets. This may have worked had the banks subsequently been put under sound regulatory supervision. Instead, after the 1991 debt restructuring, the banks not only continued to operate but also proceeded to issue new bad loans to politically-connected firms. In Poland, too, state banks “loaned” an enormous amount of money to influential ex-communists, at least half of which would never be recovered.

In a dramatic departure from the other three countries, the Laar government actually shut down insolvent state banks. It also subjected the remaining banks to an effective regime of financial supervision. This prevented the out-of-control lending that marked so many other post-communist countries. The draconian banking reform was launched in the summer and fall of 1992. After Pro Patria assumed power in October of that year, the government imposed a moratorium on lending by the three largest state banks. It then closed down one of these and merged the other two. A fourth followed later.¹⁶ As for the smaller state banks, most were shut down or allowed to fail, particularly those that had begun to lend on easy terms; as early as the beginning of 1993, seven banks whose capital adequacy ratios did not meet the government’s tough requirements had already seen their licenses revoked.¹⁷ The Bank of Estonia, the central bank, continually raised minimum capital requirements for banks. It also maintained a temporary moratorium on the issuance of new bank licenses, giving incipient financial regulatory institutions time to develop their capacity to control the new banking sector.¹⁸

¹⁵ Shapiro, “Estonia hums...”

¹⁶ The Economist Intelligence Unit, *Estonia Country Report, no. 1 (1993)* (London: The Economist Intelligence Unit); The Economist Intelligence Unit, *Estonia Country Report, no. 2 (1993)* (London: The Economist Intelligence Unit).

¹⁷ The Economist Intelligence Unit, *Estonia Country Report, no. 1 (1993)*; The Economist Intelligence Unit, *Estonia Country Report, no. 3 (1993)* (London: The Economist Intelligence Unit).

¹⁸ The Economist Intelligence Unit, *Estonia Country Report, no. 4 (1993)* (London: The Economist Intelligence Unit).

Table 7.4. Non-Performing Loans as % of All Loans, 1991-2000

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	Avg.
Estonia			7.0	3.5	2.4	2.0	2.1	4.0	2.9	1.3	3.2
Slovenia				13.8	9.3	10.1	10.0	9.5	9.3	9.3	10.2
Latvia				11.0	19.0	20.0	10.0	6.8	6.8	5.0	11.2
Hungary	11.0	21.0	29.6	20.2	12.1	9.0	6.6	7.9	4.4	3.1	12.5
Belarus				8.4	11.8	14.1	12.5	16.5	13.1	15.2	13.1
Croatia				12.2	12.9	11.2	8.2	12.6	20.6	19.8	13.9
Serbia & Montenegro				10.3	12.0	12.3	15.1	13.1	10.2	27.8	14.4
Bulgaria	40.0		6.7	6.8	12.5	15.2	13.0	11.8	17.5	10.9	14.9
Lithuania				27.0	17.3	32.2	28.3	12.5	11.9	10.8	20.0
Poland	17.0	27.0	36.4	34.0	23.9	14.7	11.5	11.8	14.9	16.8	20.8
Czech Republic	3.0	19.0	22.0	34.0	26.6	21.8	19.9	22.7	43.4	39.7	25.2
Romania	6.0	5.0	4.0	18.5	37.9	48.0	56.5	58.5	35.4	3.8	27.4
Slovakia	3.0	19.0	12.2	30.3	41.3	31.8	33.4	44.3	32.9	26.2	27.4
Moldova				31.0	36.0	45.5	26.0	32.0	29.3	20.6	31.5
Ukraine								34.6	34.2	32.5	33.8
Bosnia and Herzegovina									58.7	13.9	36.3
Albania					34.9	40.1	91.3	35.4	32.7	42.6	46.2
FYR Macedonia						66.1	59.5	50.3	62.6	46.5	57.0

*NPL levels reflect latest available data. In some cases (see references to Hungary, the Czech Republic, and Estonia below), data was not reported in the latest EBRD report. Thus, I relied on the most recently available report in which data was actually provided.

Sources: EBRD Transition Reports, 2002, 2003, 2004, 2005 (London: EBRD). Data for Hungary for 1993-96 comes from EBRD Transition Report, 2001. Data for Czech Republic for 1994 comes from EBRD Transition Report (1998). Data for Estonia and the Czech Republic for 1993 comes from Bert Scholtens (2000), "Financial regulation and financial system architecture in Central Europe," Journal of Banking & Finance 24 (525-553).

The lending moratorium imposed upon the big state banks allowed new private ones to spring up in their place. However, effective supervision by regulators prevented excessive lending by the new banks. Through steady and conservative management, their balance sheets eventually came to exceed those of the old state banks, which they proceeded to acquire and clean up. “Those new banks, of course, immediately replaced the old employees who had no expertise in modern banking,” according to Kokk, who by this time had left government to take a management role at the Estonian Savings Bank. “Generally the top management of the old banks were among the first to leave.”

The contrast from Poland in this regard was impressive; the negotiated structure of the Polish transition not only compelled regulators to allow communist-era bankers to remain in place. It also bound the government to look the other way as banks actively provided new homes to scores of ex-nomenklatura.

By the middle of 1994, a strong and financially healthy banking sector had emerged.¹⁹ This was helped along by the early adoption of a currency board to regulate the money supply under a fixed exchange rate. The currency board proved extremely successful. Among its other feats, it ensured that financially-troubled banks could not rely on state-sponsored bailouts in the event of failure.²⁰

Swiftness was absolutely key to the success of Pro Patria's program of hard budget constraints. Even if reformist governments sweep to power amidst widespread popular support, this support will inevitably wane as the realities of the policymaking process sets in, affected as it is by tradeoffs, dashed hopes, and disappointments. Furthermore, as the initial urgency of reform begins to dissipate, members of the government become increasingly susceptible to illicit overtures from corrupt business actors seeking to preserve some part of the status quo. Almost to prove this point, the Laar government fell to a no-confidence vote in parliament only two short years after it took office amidst an increasing whiff of scandal. If it had taken a gradual approach, as is often recommended by institutionalists like Joseph Stiglitz,²¹ it would not have been around long enough to see its policy goals through. And whether its considerably less radical successor would have continued in the same direction is highly uncertain.

Estonia's unmistakably unique commitment to hard budget constraints for the banking system led to a striking divergence from the other three countries in the magnitude of its bad-debt problem. The Polish banking sector nearly collapsed under the crushing weight of NPLs while those of Slovakia and Ukraine actually did collapse. In the latter two, NPLs as a share of all loans outstanding steadily increased during the 1990s, reaching peaks of 37 percent in Poland (1993), 44 percent in Slovakia (1998), and 35 percent in Ukraine (1998). Estonia's NPLs would top out at a mere seven percent in 1993 and remain modest thereafter (Table 7.4). While average annual inflation through the peak-NPL year was higher in Estonia than in Poland or Slovakia (Table 7.5), this cannot account for the former's lower NPL level; even amidst soaring inflation, total bank lending in the early 1990s was controlled far more strictly in Estonia than in the other countries (see Table 7.6 and discussion above). While the global financial crisis of 1998 did result in the failure of three of Estonia's banks, there was no systemic meltdown (NPLs reached only four percent of all loans that year) (Table 7.4). That there was no systemic banking crisis was thanks in large part to the capable management of Vahur Kraft, who took the helm at the Bank of Estonia in 1995. Well before 1997 and 1998, when financial turmoil began to engulf scores of developing countries, Kraft subdued Estonia's overheating economy by raising reserve requirements on commercial banks. The few bank failures that did take place initially prevented him from winning reappointment after his term expired in 2000. However, he returned to the post later that year after the original appointee gave up the position for health reasons. "In this second term," wrote the Economist Intelligence Unit, "Mr. Kraft has further strengthened the central bank's authority over the broader financial sector."²²

¹⁹ The Economist Intelligence Unit, *Estonia Country Report, no. 3 (1994)* (London: The Economist Intelligence Unit); The Economist Intelligence Unit, *Estonia Country Reports, no. 4 (1994)* (London: The Economist Intelligence Unit).

²⁰ *The Economist Intelligence Unit*, 9 January 2007.

²¹ See Stiglitz.

²² *The Economist Intelligence Unit*, 9 January 2007.

Table 7.5. Annual Inflation in Estonia, Poland, Slovakia, and Ukraine (%)

Country	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Poland	244.6	555.4	76.7	45.3	36.9	33.3	28.1	19.8	15.1	11.7	7.3
Estonia	.	17.2	210.6	1069.3	89.4	47.7	29.0	23.1	11.2	8.2	3.3
Ukraine	.	.	91.2	1445.3	4734.9	891.2	376.7	80.2	15.9	10.6	22.7
Slovakia	1.3	10.4	61.2	10.0	23.2	13.4	9.9	5.8	6.1	6.7	10.5

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Poland	10.1	5.5	1.9	0.8	3.6	2.1	1.1	2.4	4.3	3.8	2.7	4.3	3.6
Estonia	4.0	5.8	3.6	1.3	3.0	4.1	4.4	6.6	10.4	-0.1	3.0	5.0	3.9
Ukraine	28.2	12.0	0.8	5.2	9.0	13.6	9.1	12.8	25.2	15.9	9.4	8.0	0.6
Slovakia	12.0	7.3	3.4	8.6	7.5	2.7	4.5	2.8	4.6	1.6	1.0	3.9	3.6

Note: All data reflects national year-on-year changes. Harmonized Consumer Price Inflation unavailable for early period.

Sources: IMF, *International Financial Statistics*; *Eesti Pank Bulletin* (Estonian Central Bank); *Ukraine Economic Trends* (UEPLAC) (prior to 1999); *Slovak Statistical Office, Statistická ročenka SR* (prior to 1995)

Table 7.6. Bank Lending (% of GDP)

Country	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Estonia					13.1	14.5	16.2	22.1	32.1	31.9
Poland	27.5	19.3	21.9	19.8	19.5	17.0	16.9	19.2	20.8	22.6
Slovak Republic					56.5	40.4	36.4	43.3	55.6	53.5
Ukraine				2.6	1.4	4.6	1.5	1.4	2.5	7.8

Source: World Bank, *World Development Indicators*

In addition to preventing excessive bank lending, the Laar government implemented an effective policy of restructuring on enterprises. The program's centerpiece was a sound and well-enforced bankruptcy law.²³ The government pressured state companies, even the largest ones such as Estonian Fuel, to repay their debts to the state banks.²⁴ As early as mid-1993 – not even two years after independence – the Ministry of Economy started forcing many state-owned enterprises into bankruptcy instead of bailing them out. “To their shock, many of the banks, who had assumed that credits to state owned enterprises would be honored by the Government if the enterprises could not pay, discovered that they had to wait with other creditors for their share of recovered assets,” according to a 1996 World Bank study.²⁵ Bankruptcies began

²³ The Economist Intelligence Unit, *Estonia Country Report, no. 2 (1994)* (London: The Economist Intelligence Unit).

²⁴ The Economist Intelligence Unit, *Estonia Country Report, no. 4 (1993)*.

²⁵ Alex Flemming, Lily Chu, and Marie-Renée Bakker, "The Baltics - Banking Crises Observed," in *World Bank Policy Research Paper #1647* (Washington: The World Bank, 1996), 20. Access at <http://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-1647>.

increasing on a large scale in 1994, according to the Economist Intelligence Unit, making Estonia the only Baltic country “where the bankruptcy law has actually taken effect.”²⁶ “The hard-budget constraint in the enterprise sector, combined with the knowledge that bank bailouts would not be forthcoming, led to much more cautious lending by most of the banks,” the World Bank study added.²⁷

Thus, the Laar government not only refrained from propping up the state banks but also refused to provide special treatment to other state-owned enterprises. It thereby confounded predictions by some economists who argue that privatization is a necessary condition for hard budget constraints. If the Estonian experience is any guide, state firms too can just as easily face the wrath of market competition if the government is sufficiently committed to this policy.

As in Poland and Slovakia, the Estonian government reined in direct subsidies to insolvent enterprises (although the loss-making Estonian Oil Shale Company continued to be heavily subsidized).²⁸ Such policies proved disastrous for some sectors of the economy, particularly in capital-intensive industries such as pulp and paper, chemicals, engineering, and metals.²⁹

Unlike in the other three countries, however, Estonia also shunned the impulse to grant subsidies to politically-connected firms (which, unlike chronic loss-makers, are often perfectly solvent).³⁰ With a few notable exceptions, state companies in Estonia tend not to serve as cash cows for influential elites as they do in Poland, Slovakia, and Ukraine. Ruling parties certainly dish out do-nothing jobs on company boards to their deputies, “but they just want to come in for a few months and get paid,” says one source. “It’s not dangerous to the company.”³¹ In addition, by instituting a 26 percent flat tax in 1993, the government deprived firms of the opportunity to receive politically-engineered tax breaks.³² The Laar government rigidly adhered to its policy of hard budget constraints despite fierce and growing opposition from all segments of society, represented most fervently by Savisaar’s opposition Center Party.³³

The system of public procurement has never met the harsh criticisms for corrupt dealings as seen in most other post-communist countries; “regarding the majority of ministries,” according to one recent report, “findings attested to general adherence to the Public Procurement Law. There is also other anecdotal evidence that [the] correct functioning of the public procurement system is the rule and violations are more of an exception. According to the lawyer Veiko Vaske this is confirmed ‘by the fact that only 4 percent of all public procurements are actually disputed’.”³⁴

²⁶ The Economist Intelligence Unit, *Estonia Country Reports, no. 4 (1994)*.

²⁷ Flemming et al., 20.

²⁸ The Economist Intelligence Unit, *Estonia Country Reports, no. 4 (1994)*.

²⁹ Nørgaard and Johannsen, 137-43.

³⁰ Ibid., 131-33.

³¹ Interview with Respondent #105.

³² Nørgaard and Johannsen, 131-33.

³³ Anatol Lieven, *The Baltic Revolution: Estonia, Latvia, Lithuania and the Path to Independence* (New Haven, CT: Yale, 1993), 359.

³⁴ Valts Kalniņš, *Estonia: Almost There* (Riga: Centre for Public Policy PROVIDUS, 2013). Access at http://anticorpp.eu/wp-content/uploads/2014/03/Estonia-Background-Report_final.pdf.

Privatization in Estonia

As previous chapters have showed, an important additional form that soft subsidies often take is underpriced privatizations. Compared to Ukraine, Slovakia, and even Poland, Estonian privatization is widely regarded to have proceeded with remarkable honesty.

This is not to say that former communist managers were excluded from the process. For a brief period in 1991 and early 1992, before major privatization got underway, a group of the most important state-enterprise managers around the Ministry of Industry began setting up private management companies. These firms retained exclusive rights to sell the goods produced by the state enterprises. “But this was not actual asset-stripping, as that was very difficult to do because of the politics and law here,” recalls Raivo Vare, who as State Minister played a key role in the transition process. “If a company went down because of its debts, it usually went along with its assets.”³⁵

Nevertheless, these one-sided deals allowed some communist-era managers to accumulate significant wealth. This enabled them to participate in the privatization of their respective enterprises later on. “But the difference in Estonia,” according to Vare, “was that, at a very early stage, even during the Vāhi transitional government [January-September 1992], a special advisory committee was invited from the German *Treuhand*, headed by Dr. [Herbert] Schmidt. And from late 1992 and early 1993, the privatization of industry was conducted almost entirely in the form of the standardized and procedure-driven privatization auctions, not by simple asset-stripping like in many other former Soviet-bloc countries. This was part of the reason behind the success story of the Estonian economy.”³⁶

Indeed, the Estonian Privatization Agency (EPA) was modeled closely on the *Treuhand*, the state body that oversaw the privatization process in the former East Germany. The EPA did not necessarily favor bidders who offered the highest price. It rather gave preference to those who could demonstrate a reliable business plan and investment strategy as well as good management skills and sufficient capital.³⁷ The prices paid were certainly cheap. But every privatization contract came along with investment obligations on the part of the purchaser; when the total cost incurred by the buyer is taken into account, the privatizations hardly constituted giveaways. In addition, the EPA routinely followed up to make sure the new owners fulfilled their investment requirements within the stipulated time frame.³⁸ As a result, the agency “proved to be an important counter-weight to those political forces that continued to lobby for insider privileges in the privatization process.”³⁹

Even though ex-communists and enterprise managers participated in the privatization process, “the prices were the same for everybody,” Kokk insists. He attributes this to the government’s reliance on Schmidt for both the design of the privatization program and advice on implementing it. “This meant that there was an advertisement in the FT [*Financial Times*] and *The Economist* stating that these

³⁵ Interview with Raivo Vare, 18 November 2008.

³⁶ Ibid.

³⁷ Nørgaard and Johannsen, 138.

³⁸ Interviews with Aavo Kokk, Peeter Lepik. Also see The Economist Intelligence Unit, *Estonia Country Report, no. 2 (1994)*.

³⁹ Nørgaard and Johannsen, 138.

properties are for sale, there is an auction, and bids will be accepted up to a certain date. And so it was done. But it was very fast; the time from the advertisement to the bid was sometimes only one month. So, of course, the local people had some advantage. But the price was the same for everybody.” Not only that, but those responsible for negotiating the price with prospective buyers were not connected in any way to the state enterprise that was being sold; they were rather employed by the EPA itself. They also tended to be very young. Consequently, few if any had links to the old communist establishment, including the enterprise managers, who mostly represented an older generation.⁴⁰

The larger privatizations, for their part, were handled almost entirely by foreign consultants from Germany, Denmark, and other Western countries. “This avoided situations where such questions were decided by Estonian officials, who had their own local relationships and obligations,” says Peeter Lepik, a lawyer who was involved in most of the big privatizations. “Since Estonia is a small country, it could have easily gone in another, less transparent direction because everyone knows each other. But the way it was handled here was more transparent than in a number of other countries.”⁴¹

This point is confirmed by Arnold Sinisalu. He is the current director of the Security Police (*Kaitsepolitseiamet*, or KaPo), although at the time I interviewed him he was the agency’s Tallinn District Head. He says that bribery was difficult to pull off in the privatization process because there typically were 10 to 15 people deciding on each sale. Most of the problems his agency dealt with concerned questions about the use of false identities by the winners of certain privatizations.⁴² Anton Sigal, a prominent attorney, explains that most privatizations - especially the larger ones such as the Estonian Shipping Company, Estonian Air, and the Saku Brewery - were conducted through legitimate tenders. “The privatization agency acted more as investment bankers than state officials. They engaged law firms to assist in the management of the sales and the process was handled professionally.”⁴³

In the end, most privatizations were awarded either to foreign investors or enterprise managers (through manager buyouts).⁴⁴ However, in the early stages, and in most of the large privatizations, the sales often went to foreigners since managers lacked the capital required to participate. This very fact suggests that, in order to win, participants actually had to put up substantial amounts of money. This is a far cry from the corrupt farces that marked the sales of many Ukrainian and Slovakian enterprises.⁴⁵ Not only was the privatization process clean, it was completed with remarkable speed; by 1995, 90 percent of all state firms had been privatized.⁴⁶

While most privatizations were done honestly, some were not. In fact, the first person appointed as head of the EPA was dismissed for alleged corruption after only ten days.⁴⁷ Indeed, two of the EPA’s directors ended up going to jail. One was convicted for

⁴⁰ Interview with Aavo Kokk.

⁴¹ Interview with Peeter Lepik.

⁴² Interview with Arnold Sinisalu.

⁴³ Interview with Anton Sigal.

⁴⁴ Nørgaard and Johannsen, 138.

⁴⁵ Interview with Peeter Lepik.

⁴⁶ See *PrivatizationBarometer.net*, accessed 10 August 2014 at <http://www.privatizationbarometer.net/atlas.php?id=24&mn=PM>.

⁴⁷ Lieven, 333-34.

crimes committed after he left the agency. But the other, Jaak Liivik, went to prison for his role in the 2001 privatization of Estonian Railways. His crime was to sign a contract that unlawfully obliged the state to cover certain financial liabilities of the firm.⁴⁸ The Estonian Railways privatization was the launch-pad for multiple scandals. At one point, the EPA announced the company's sale to one "Tony Massona," the alias of an American citizen with a criminal background. Authorities canceled the deal as a result and it was eventually sold to the far more reputable Baltic Rail Services (though with dire consequences for the new owner, as we will see in due course).⁴⁹

Scandal also tainted the sale of the Viru Hotel in 1993, which drew controversy for what many regarded as an artificially low price as well as links between the Finnish buyers and Indrek Toome, a former top-level communist.⁵⁰ In 1997, during the second premiership of Tiit Vähi, Silmet, a producer of rare earth metals, was privatized to a Swedish company in which, it was alleged, Vähi himself owned shares. In addition, the aborted privatization of the Narva Power Station failed after it emerged that NG Energy, the Dutch firm that won the tender, had no experience whatsoever in the electricity business.⁵¹ Questions also surrounded the privatizations of a number of small enterprises, particularly when responsibility for managing the sales rested with municipal governments. An example was the Kalev confectionary, which was sold to Oliver Kruuda, a politically-connected businessman.⁵²

Although improprieties did occur, few privatizations were marked by the outright fraud that characterized the sales of so many Ukrainian and Slovakian firms; blatant giveaways in rigged auctions were mostly unheard of in Estonia. This made it far more difficult for political thugs to win the competitions. The fact that most of the biggest privatizations in particular were conducted honestly ensured that few political thugs would make it into the plutocratic elite.

The main reason for the relative lack of fraud in the biggest Polish privatizations was the robustness of party competition. As in Poland, party competition in Estonia was strong from the very start.

Like Poland, and unlike Slovakia, Estonia would come to be characterized by a succession of alternating party coalitions in power. Disenchantment with market reforms led to the ouster of the Pro Patria coalition in the fall of 1994. Elections in March of 1995 resulted in a new government led by Tiit Vähi's Estonian Coalition Party, but Vähi resigned amidst scandal in February 1997 and was replaced by Mart Siimann (also of the Estonian Coalition Party).⁵³ The next elections, in March 1999, ejected the Estonian Coalition Party in favor of Mart Laar and the Pro Patria Union, who would rule for the next several years alongside the Reform Party and the Moderate People's Party, or *Rahvaerakond Mõõdukad* (leave it to the sober Estonians to draw excitement from the

⁴⁸ The European Court of Human Rights, "Chamber Judgment: Liivik v. Estonia. Press Release Issued by the Registrar," (European Court of Human Rights, 2009). Available at [http://hudoc.echr.coe.int/sites/eng-press/pages/search.aspx?i=003-2780947-3044226 - {"itemid":\["003-2780947-3044226"\]}](http://hudoc.echr.coe.int/sites/eng-press/pages/search.aspx?i=003-2780947-3044226 - {).

⁴⁹ Interview with Enno Tammer.

⁵⁰ Ibid.

⁵¹ Ibid.

⁵² Interview with Anton Sigal.

⁵³ "Estonian Government Changing in Slow Motion," *Eurasia Daily Monitor*, 26 February 1997 (http://www.jamestown.org/single/?tx_ttnews%5Btt_news%5D=5643&tx_ttnews%5BbackPid%5D=211&no_cache=1).

“moderate” label). Disillusionment with the established right-wing parties, namely Pro Patria, spurred the rise of a new rightist party, Res Publica, in 2001. Regarded as the only viable means of averting a victory by Savisaar’s center-left party, Res Publica won the ensuing elections in 2003 and formed a government thereafter.⁵⁴

The pattern of successive alternation in power by competing parties would be broken from 2005 onward with the ascendance of the Reform Party under Andrus Ansip, another right-wing party. Ansip became Prime Minister that year. His party, which had been the junior coalition partner of Laar’s Pro Patria Union from 1999 to 2003, would emerge victorious in both the 2007 and 2011 elections, making Ansip the longest-serving incumbent Prime Minister in post-communist Estonian history.⁵⁵

Until 2007, however, each election led to the ouster of the ruling coalition in favor of a new one. Clearly, then, opposition parties were *credible* in the sense that they consistently threatened successive governments with removal in national elections. This is the first of our three dimensions of party system strength. It is evident in the fact that the longest-serving Estonian government during the main era of privatization, like its Polish counterpart, stayed in power only 48 months. This compares to 92 months for the equivalent Slovak government (Table 7.7).⁵⁶

But the continuous alternation of governing parties masked an even greater source of competition lurking continuously beneath the surface: Edgar Savisaar and the Center Party. In contrast to Poland, Hungary, Lithuania, and Slovenia, the Estonian communist party did not regenerate itself into a social-democratic organization.⁵⁷ This was due to certain peculiarities unique to Estonia, namely a widespread consensus on the virtues of the free market. However, standing in for a reformed communist party was Savisaar’s Center Party, which proved a staunch and consistent opponent to one post-communist government after another. Thanks to its relentless anti-government crusades, ruling coalitions were “forced to take desperate measures in order to stay in power.”⁵⁸ “In its dual role as the most vehement critic of successive governments and the biggest magnet for controversy and criticism,” Grzymala-Busse writes, “the Center Party acted as an equivalent of the communist successor parties - both the source and target of the opposition.”⁵⁹ That ruling coalitions confronted the constant danger of losing power in the next elections was due in large part to the crucial role played by the Center Party.

In addition to the threat of removal, the Estonian party system was further strengthened by the fact that practically all parties in parliament represented *plausible* candidates for inclusion in governing coalitions (Table 7.7).⁶⁰ Ironically, the disenfranchisement of the Russian-speaking minority strengthened party competition in this respect. It did so by preventing the election of parties that would otherwise have been excluded from participation in governing coalitions. Due to the strong antipathy many Estonians had toward recent Russian-speaking immigrants, mainstream parties may

⁵⁴ Rein Taagepera, “Meteoric Trajectory: The Res Publica Party in Estonia,” *Democratization* 13, no. 1 (2006).

⁵⁵ “Estonia busts another stereotype,” *The Economist*, 7 March 2011 (http://www.economist.com/blogs/easternapproaches/2011/03/estonias_election).

⁵⁶ Grzymala-Busse, 10-14.

⁵⁷ *Ibid.*, 71-73.

⁵⁸ *East European Constitutional Review* (Winter 2001), quoted in *ibid.*, 72.

⁵⁹ *Ibid.*, 72.

⁶⁰ *Ibid.*, 10-14.

Table 7.7. Party Competition Indicators

Questions per MP*		Questions per MP in Ukraine (by Year)		Longest Tenure of Ruling Party in Office During Main Era of Privatization		
Questions per MP (by Country)				Country	Longest Tenure (months)	Dates
Estonia	3.54	1998	0.40	Estonia	48	Mar. 1995 to Mar. 1999
Poland	3.78	1999	0.93	Poland	48	Oct. 1997 to Oct. 2001
Slovakia	0.94	2000	0.65	Slovakia	92	Nov. 1998 to July 2006
Ukraine	1.22	2001	0.73			
		2002	0.54			
		2003	2.08			
		2004	2.51			
		2005	4.13			
		2006	0.94			
		2007	0.08			
		2008	0.38			
		2009	0.92			
		2010	0.67			
		2011	1.43			
		2012	1.18			
		2013	1.93			
		Average	1.22			

Average Seat Share of Plausible Parties	
Country	Avg. Seat Share (%)
Estonia	1.00
Poland	0.97
Slovakia	0.81

*Average annual number of questions asked per MP

Sources: Grzymala-Busse (2007), 14; Grzymala-Busse (2003); Verkhovna Rada Department of Control (Ukraine)

have been expected to shun cooperation with parties seen as representing the members of Russian-speaking groups. But the fact that such parties had relatively little representation in parliament meant that a greater number of seats were occupied by other parties that were potentially acceptable as members of a ruling coalition. This helped to boost the overall quality of party competition in Estonia (even if it took away from the overall representativeness of the Estonian parliament). Junior partners in successive governments could credibly threaten to leave the coalition and form a new one with alternative parties. This reduced their dependence on senior coalition partners and enhanced their ability to effectively monitor them as a result.⁶¹ Recall how a relatively large percentage of Slovak parties were not considered viable coalition partners. Whereas only 81 percent of deputies in successive Slovak parliaments were deemed acceptable as potential coalition members, a full 100 percent of their Estonian counterparts were.⁶² Therefore, a scenario similar to Slovakia, where the junior partners of the HZDS remained dependent on it thanks to their status as parliamentary outcasts, was far less conceivable in Estonia.

Aside from being credible and plausible, the Estonian opposition also satisfied the third dimension of strong party competition noted by Grzymala-Busse: it was consistently *critical* of the government. Political parties monitored each other closely during the first post-communist decade, when virtually all privatizations took place. On average, parliamentary deputies asked 3.5 questions each every year through 2004 (Table 7.7).

⁶¹ Ibid., 72.

⁶² Ibid., 14, 72.

Just as strong party competition accounted for the absence of blatant privatization fraud in Poland, it would also play a key role in Estonia. During the 1992-95 Pro Patria government, vigorous competition among parties was likely not essential for ensuring a clean privatization process. The reason was that the ruling coalition displayed an absolute commitment to hard budget constraints in all realms, including but not limited to privatization. Even if party competition had not been as robust as it was, it is hard to imagine the Laar government freely handing out state companies to cronies for pennies on the dollar. Indeed, the National Audit Office (*Riigikontroll*), the equivalent of Poland's Supreme Audit Office (NIK), did not gain the broad enforcement powers and political independence it would later be known for until 1995⁶³ – after the privatization process was well under way. And yet the privatizations overseen by the Pro Patria government were remarkably honest and free of overt corruption, as we saw above.

However, as the 1990s wore on and the sense of urgency to the reform process abated, the *Riigikontroll* arguably became an important mechanism underpinning the integrity of large privatizations. In July 2001, for instance, it ruled that the Estonian Privatization Agency had saddled the state with illegal financial obligations in the privatization of Estonian Railways to Baltic Rail Services.⁶⁴

Political Thugs in Shortage

This is not to say that all the new business elites of Estonia were paragons of rectitude. Toivo Tänavsuu, a well-known investigative journalist, goes so far as to claim that not a single prominent Estonian businessperson is perfectly honest. “In Estonia, we have a saying - J.O.K.K., which means ‘Juridically Everything is Correct.’ You can often tell that something is amiss but, technically, everything is done within the law.”⁶⁵

Nevertheless, the country clearly lacks the dense networks of political thugs who control so much of the business and political realms in Poland, Slovakia, and Ukraine. The main result of hard budget constraints in Estonia was to marginalize most would-be political thugs before they could establish a firm foothold in business. During the late 1980s and early 1990s, Estonia, like most East European countries, saw a flourishing of organized crime. Criminal groups profited by extorting protection money from the legal business sector. It also derived revenues from illegal businesses, namely smuggling, which was extremely lucrative given the country's geographical proximity to St. Petersburg and its access to the sea. In contrast to most other countries, however, the criminals and former secret service officials who profited from these schemes found themselves largely cut off from the most lucrative source of illicit wealth - state assets.⁶⁶ The reason was simple: most such opportunities did not exist thanks to stringent budget constraints imposed by Estonia's first post-communist governments.

A handful of individuals with backgrounds in organized crime did manage to legalize their assets and move into legitimate business activities. Among these were a prominent mafia figure from the early 1990s who now owns a hotel and convention

⁶³ Ibid., 100.

⁶⁴ Kairi Kurm, “Estonian railway privatization threatened,” *The Baltic Times*, 19 July 2001 (<http://www.baltictimes.com/news/articles/5223/>).

⁶⁵ Interview with Toivo Tänavsuu.

⁶⁶ For examples and statistics, see Lieven, 325., and Nørgaard and Johannsen, 117-20.

center in suburban Tallinn. There was also a former boxing champion who became one of the biggest importers of cigarettes into Estonia during the 1990s (and continues to have an impact in the criminal world today). Another criminal authority transformed himself into an honest businessman after surviving several assassination attempts. He now ranks among the top-500 richest Estonians.⁶⁷

As in the other three countries, many former communists went into business as well. According to Steen and Ruus, who examined where the members of the old communist elite ultimately ended up, 34 percent of the 1986 Central Committee had entered private business by 1996. The same was true for 55 percent of the 1990 Central Committee.⁶⁸ “These other guys with a history in the KBG and the communist party all went into business,” according to a state prosecutor who worked during the communist period and continues to serve today. “They couldn’t be hired into state jobs and they had to feed their families somehow.”⁶⁹

Nevertheless, the shortage of soft budget constraints ensured that few would-be political thugs lasted in business very long. And even fewer made it to the top of the business elite, as we will see. In the very early 1990s, four “families” emerged at the top of the banking, real estate, and hotel sectors. These included the families of three ex-communists - Bruno Saul, the former hardline Prime Minister; Olari Taal, who directed a large construction company and later joined two post-communist governments; and Uno Veering, another red director and a deputy prime minister in the Vāhi government. (The fourth family was made up of Canadian émigrés.) Much of their wealth allegedly came from having bought up valuable real estate at low state prices which they subsequently sold at a handsome profit.⁷⁰ However, except for Taal, none of them remain on *Äripäev*’s list of the top-500 Estonians today. This suggests that any soft budget constraints that may have been available in the late communist period quickly dried up after independence.

While few political thugs made it to national prominence, some have attained success on the local level. They have found a welcome source of soft budget constraints in certain municipalities, from fraudulent public procurement tenders to shady real estate deals. To the extent that corruption is a problem in Estonia, it is in the municipal governments rather than the central or regional administrations, according to Mari-Liis Sööt, the top anti-corruption specialist at the Ministry of Justice. City councils are often composed of local businesspeople seeking to use their positions for private gain. They are aided in their efforts by close ties to mayors and other municipal officials.⁷¹ As of 2008, the only person to have ever been prosecuted for involvement in corrupt public tenders was Aavo Keerme, a mayor in Ida-Viru county. He stood trial for alleged influence-peddling in connection to a contract with a local business to provide street-cleaning. After the tender, he inserted a special clause into the agreement enabling the business to ratchet up the price it received by a multiple of four to five times the original

⁶⁷ Interview with Respondent #126.

⁶⁸ Steen and Ruus, "Change of Regime – Continuity of Elites? The Case of Estonia," 242 (Table 4) and 243 (Table 5).

⁶⁹ Interview with Respondent #107.

⁷⁰ Lieven, 101.

⁷¹ Interview with Mari-Liis Sööt.

bid. That said, the amount of money involved - about EEK2.5 million - was rather small.⁷²

The Tallinn city government has also attracted considerable notoriety for corruption. “What happens on the local level is that, whenever a new government is elected to power, they start replacing people all the way down to the lowest levels - even the janitors,” says Andres Anvelt, the former Director of the Central Criminal Police. “In Tallinn, one party [the Center Party] has been in power for two straight terms. They put their own people in the city administration. It now works like a party office, not a city government. All decisions are made within the party, not the government - for example, what to do with public land, what to sell, and who to sell it to.” Bribery is not even necessary, according to Anvelt; “if someone wants to win a contract, he donates to the party and the decision then passes easily through the city council because the council is controlled by the party.”⁷³

One example of a local political thug is Nikolai Ossipenko, who served as a police commissioner in the late 1980s.⁷⁴ He operates in the city of Kohtla-Järve in northeastern Estonia in the predominantly-ethnic Russian region of Narva. He has made a small fortune through questionable tenders with the city government. According to Erik Gamzejev and Erik Kalda, two local journalists who have investigated his activities, Ossipenko’s company N&V regularly receives 20 percent of the city’s budget. It cleans the streets, repairs the roads, cuts the grass, sweeps the leaves from public parks, installs the traffic lights, and collects the garbage. Given N&V’s dominance over municipal services, few other businesses bother coming to Kohtla-Järve to try their hand in public tenders. “His company has grown so rich from its Kohtla-Järve contracts that no competitor can come here,” Gamzejev and Kalda report. “And when there is no competition, ordinary people pay more for these services.”

Ossipenko holds a seat on the city council, where he represents Savisaar’s Center Party. According to the journalists, the same Center Party figures have been in control of Kohtla-Järve since 1996. “They’re all old friends. Under communism they had already begun to manage the situation.” The leader of the local “power circle” is Valeri Korb. Korb was the last mayor of the city before independence. He lost his position in 1991 but was re-elected in 1996. At one point he was prosecuted for allegedly granting himself an illegal EEK40,000 bonus as mayor. But his legal team succeeded in dragging out the case for so long that prosecutors decided the cost of continuing their pursuit outweighed the magnitude of the purported violation. After this he managed to win election to the national parliament - thanks in no small part to Ossipenko’s support. He remains influential in local politics today.

Gamzejev and Kalda describe the local Center Party organization as a typical party machine that disburses patronage to key supporters in return for mobilizing votes at election time. Investigating its role in three elections to the city council as far back as 1996, they found that the party attracts votes by placing local notables on the party list.

⁷² “Lõpetati Jõhvi endise linnapea kriminaalasi,” *Postimees*, 16 September 2009 (<http://www.postimees.ee/164753/lopetati-johvi-endise-linnapea-kriminaalasi>); Interview with Erik Gamzejev and Erik Kalda, 13 November 2008.

⁷³ Interview with Andres Anvelt, 28 February 2014.

⁷⁴ Unless otherwise noted, the following information on Ossipenko and comes from an interview with Erik Gamzejev and Erik Kalda, 13 November 2008.

These tend to be individuals such as school principals and teachers who are well-liked and in a position to bring out the vote for the party. The party organization buses citizens to voting stations, promises them money or vodka, and instructs them who to vote for.

The Center Party demonstrated its near-invincibility in 2005 when it trounced an alliance of all the other local parties which had formed with the sole intention of ousting it from power. The opposition obtained only six of the available 21 seats on the council with the rest going to the Center Party. Gamzejev and Kalda discovered that all but one of the school principals in Kohtla-Järve belonged to the Center Party. The lone dissenter, a popular and well-regarded principal who supported Pro Patria, found herself out of a job as soon as her contract expired. Naturally, her successor had a place on the Center Party list (most people who get onto the list do not end up getting elected, but are there merely to attract the support of local voters). In the elections analyzed by the two journalists, school principals were tasked with mobilizing 100 votes each for the party. Their success or failure would often determine how quickly their schools would get repairs done and obtain budgetary allotments for new hires.

Technically, the municipal government is accountable to the city council, which appoints its members. In practice, most council deputies are businesspeople who depend on municipal contracts and other benefits from city hall. This often renders it little more than a rubber stamp. The networks linking local business actors to municipal officials create a business environment tilted against firms that lack the requisite political connections. For instance, city approvals for building and construction plans can be obtained with greater speed by favorites of the mayor. Nevertheless, one city council member in Narva was convicted of accepting bribes to speed up regulatory approvals. More recently, Feodor Ovsjannikov, another Narva city council member, was arrested for arranging under-the-table payments from local companies to an allied business in exchange for letting them participate in public tenders. Several additional members of the local government resigned their positions as a result of the scandal.⁷⁵ “This shows that the separation of powers does work here,” Gamzejev admits.

In the big scheme of things, businesspeople like Ossipenko are small fish compared to the largest players on the local scene - namely Tiit Vähi, Viru Keemia, and the state-owned electricity station. Such heavyweights generally do not have to worry about cultivating ties to local authorities.

Furthermore, although local corruption can be extensive, it is a different beast than in Poland, Slovakia, and Ukraine. For instance, as the chapter on Poland demonstrated, business actors lacking strong ties to local political networks are vulnerable to predation by those who do have such connections. This phenomenon is unheard of in Estonia, according to my respondents. Journalist Toivo Tänavsuu acknowledges that donations to local politicians can help ensure the smooth operation of one’s business. But, he insists, “it is not a must.” The donation is simply a form of insurance that one’s interests will be taken into consideration if the need arises. However, businesses that avoid relationships with local bigwigs do not become exposed to harassment or attacks.⁷⁶

⁷⁵ “How business mixes with politics in Narva,” *Äripäev*, 28 June 2012.

⁷⁶ Interview with Toivo Tänavsuu, 30 October 2008.

Criminal Corporate Raiding Among the Non-Plutocratic Elite

The relative absence of political thugs among the non-plutocratic elite has translated into a similar lack of raiding. In the entire course of my investigation I was only able to identify four definite raids in this sphere. They span two of the nine economic sectors under consideration, one of which is real estate and the other is transportation and storage. This stands in contrast to Poland, which has at least one raid in seven sectors, as well as Slovakia (eight) and Ukraine (seven). Table 7.8 contains a breakdown of the non-plutocratic raids according to the indicators of raiding found in each case.

When asked about the kinds of criminal corporate raids observed in the other three countries, my respondents, without exception, insisted they are not a normal occurrence in Estonia. To the extent that they took place at all, they tended to happen in the early 1990s and were mostly restricted to businesses operating in the grey economy. Aavo Kokk, who has been active in both the public and private sectors since before independence, recalls a few illicit takeovers in the shadowy business of importing Russian gas. Yet none resembled Polish-style attacks where the target was imprisoned on trumped up charges; they merely involved the “creative interpretation of the law,” as he puts it. Regardless, he says, they no longer happen; “now those businesses have been crowded out of the market,” he explains. “I haven’t heard about this kind of thing happening in years.” He does remember a case in southeastern Estonia where a prominent businessman who spoke out about local-government malfeasance was denied a business license. But this was hardly an attempted takeover.⁷⁷

During the interviews, I would typically run through a list of the different types of criminal corporate raids I found in Ukraine, Slovakia, and Poland. The use of state agencies to harass or intimidate targets? Hiring a private security team to seize the premises of another business? Artificial bankruptcies? Influencing a judge to freeze the assets of a majority shareholder? Asked to recall such instances, my sources time and again came up short. Among those who noted the rarity of these sorts of takeovers were Heili Sepp, head of the Criminal Policy Department of the Ministry of Justice and a former state prosecutor; Merike Varusk, a civil judge; Piret Reiljan, Sten-Aleks Pihlak, and Meelis Mandel from the prominent newspaper *Äripäev*; Erik Gamzejev and Erik Kalda, the investigative journalists from Narva; and Hans Luik, a wealthy businessman and one of Estonia’s plutocrats.

As we will see in due course, the holding of illegal board meetings does happen with some frequency. However, in Estonia, decisions taken at such meetings do not require authorization by an agent of force (i.e. a judge) as they do in the other countries. When they do take place, they are typically the work of low-level criminals targeting small businesses. Locally prominent businesspeople like Ossipenko may be able to arrange fraudulent tenders. They might also manage to create difficulties for other businesses - for instance, by ensuring they are denied access to municipal contracts. But they generally cannot enlist the help of police, prosecutors, or judges in their takeover attempts, say Gamzejev and Kalda. Piret Reiljan, Sten-Aleks Pihlak, and Meelis Mandel of *Äripäev* confirm this view.⁷⁸ The reason, according to Mari-Liis Sööt of the Ministry

⁷⁷ Interview with Aavo Kokk.

⁷⁸ Interview with Erik Gamzejev and Erik Kalda; Interview with Piret Reiljan, Sten-Aleks Pihlak, and Meelis Mandel.

Table 7.8. Alleged Non-Plutocratic Raids: Confirmation Indicators

<u>Indicator #</u>	<u>Indicator Key</u> <u>Description</u>
1	Many domains
2	Spontaneous public actions
3	Unrelated offenses
4	Non-existent laws
5	Suspicious bankruptcy / redistribution
6	Repeated investigations/prosecutions
7	State action in midst of political conflict
8	Direct force
9	Threats made
10	State actions ruled (or suspected to be) illegal
11	Target is a rival of powerful interests
12	#2, 8, or 9 coincides with state action
13	Illegal board meeting

<u>Raid #</u>	<u>Target</u>	<u>Indicators</u>													<u>Substantiated?</u>		
		1	2	3	4	5	6	7	8	9	10	11	12	13			
1	La Ferme								X	X							Y
2	Flora Vara								X							X	Y
3	Agrolinda								X	X							Y
4	Vasara								X								Y

of Justice, is that these officials are not employed by municipal governments, where most of the corruption is happening, and cannot be bribed.⁷⁹

One of the four definite raids I uncovered was an attempt to seize control of La Ferme, a real-estate holding company owned by Hans Luik, the plutocrat referenced above.⁸⁰ Around 2005, he began buying up shares in the Soviet-era enterprise, which is situated on valuable real estate, and managed to acquire a majority stake. But a group of criminals led by underworld baron Imre Arakas also had an eye on the company and were briefly detained by police over the incident. During the course of the raid, Molotov cocktails were thrown into the homes of Luik’s attorney as well as his mother-in-law. Arakas reportedly sent a threatening text message to Luik as well. They criminals tried to pass off forged documents transferring Luik’s shares to themselves.⁸¹

The second non-plutocratic raid involved a shareholder dispute over Flora Vara, a warehouse operator.⁸² Flora Vara is unusual in that the perpetrators of the attack were

⁷⁹ Interview with Mari-Liis Sööt. This view is confirmed by Erik Gamzejev and Erik Kalda.

⁸⁰ Non-Plutocratic Raid #1

⁸¹ Lauri Linnamäe, “Laferme kinnisvaratüli jõudis kohtusse, politseisse ja Vene allilma,” *Postimees*, 26 May 2007; Peeter Raidla, Kadri Jakobson, “Rünnaku Luige vastu tõi Laferme ärikeskus,” *Äripäev*, 26 January 2007 (<http://arileht.delfi.ee/archive/runnaku-luige-vastu-toi-laferme-arikeskus.d?id=14917680>); “Five men suspected of involvement in attacks on Luik released,” *Baltic Business News*, 26 January 2007 (<http://www.balticbusinessnews.com/Default.aspx?PublicationId=d9196ad8-4052-4fc4-abaa-3ced6d40d81a>); “Arakas threatened Hans H. Luik over real estate – paper,” *Baltic Business News*, 26 January 2007 (<http://www.balticbusinessnews.com/Default.aspx?PublicationId=5d448e251-ef8a-45c1-89cd-242886219bd8>); Interview with Peeter Raidla.

⁸² Non-Plutocratic Raid #2

seemingly not political thugs; it simply appears to have been a case of normal businesspeople resorting to illegal methods to resolve one specific dispute. The parent company, Flora, had been privatized in 1993 to its five longtime managers. The battle pitted two minority shareholders, owners of 49 percent, against the other three shareholders, who held the remaining 51 percent. The two sides came to blows in 2004 over the composition of Flora Vara's supervisory board. When the group of three failed to get their way, they demanded that the other two shareholders, Rita Kull and CEO Elmar Kruusma, buy them out. However, the two sides could not agree on a price. This led Kruusma and Kull to hold a disputed board meeting at which additional shares were issued. They refused to allow participation in the share offering by the other three shareholders, who responded with a failed attempt to appoint one of their own as CEO.

With the two sides in deadlock, the apparent solution was to resolve the matter by force. What followed was a "scuffle between pre-retirees," in the words of Sulev Vedler, a journalist who wrote about the case. In late December 2004, a team of twenty thugs and off-duty police officers surrounded Flora's main office. With Kruusma and Kull inside, they broke down the exterior glass wall and stormed the premises, dragging Kruusma out of the building on the very chair he was sitting in. Another employee, Jaan Lindmäe, was similarly evicted, after which he had to be whisked away in an ambulance wearing an oxygen mask. In the meantime, dozens of lawsuits concerning the case continued to clog the civil courts. "The only winners in this situation are the lawyers, with their hourly fees of 1500 kroons plus value-added-tax," wrote Vedler.⁸³

Another raid resulted in the expropriation of Paul-Osmar Soidla and Paul Orupõld, who held 51 percent of Agrolinda, a real estate management company.⁸⁴ In late 1996, fellow Agrolinda shareholder Eeva Ojamets phoned Orupõld at home and demanded he meet her to discuss some real estate transactions. Because Orupõld was on sick leave at the time, Orupõld sent Robert Silajev to drive him. On the way back he requested that Silajev drop him off; he wished to make the rest of the trip home on foot. While walking, three men in a blue van pulled alongside Orupõld and pulled him inside. They drove him around for several hours, forcing him to sit on a seat they had quite visibly wired up to electrocute the passenger. "They told me right away that I had to sell my shares and couldn't tell anyone about it." Orupõld signed the papers; "I am an electrical engineer and know very well what can be done with those wires," he notes.⁸⁵

Disobeying his captors' orders, he did report the incident. However, at the police station he found the very men who had threatened him hamming it up with the officers: Tõnis Porgand, the driver; Mart-Peeter Erss, a department head at the Ministry of Economic Affairs; and Tarmo Kattago, who had been sitting in the back with Orupõld. "They all had alibis and I was alone with no witnesses," he laments. The police terminated the criminal investigation for lack of evidence.⁸⁶

Orupõld subsequently found that his home phone was being tapped. Occasionally he would receive a call reminding him to keep his mouth shut. A short while later, in

⁸³ Sulev Vedler, "Scuffle Between Pre-Retirees," *Eesti Ekspress*, 5 January 2005.

⁸⁴ Non-Plutocratic Raid #3

⁸⁵ Sirje Niitra, "Firmade ülevõtmine: ärimeeste grupeeri pressis omanikelt aktsiad välja," *Ärileht*, 16 December 1997 (<http://arileht.delfi.ee/news/uudised/firmade-ulevotmine-arimeeste-grupeeri-pressis-omanikelt-aktsiad-valja.d?id=50749309>).

⁸⁶ Ibid.

February 1997, a general meeting of Agrolinda took place. It resulted in the election to the board of Eeva Ojamets, Orupõld's business partner whose initial phone call had created the pretext for him to leave the house that fateful night. Robert Silajev, who had driven Orupõld to the meeting with Ojamets, was appointed Managing Director. The criminals then tunneled Agrolinda's property out of the company through a series of transactions involving, among others, three notorious criminals, Jaak Veike, Priit Kajar, and Ahti-Kullervo Jõgi. The remaining minority shareholders in Agrolinda "gave" their shares to Jõgi as a "gift." Imre Arakas, the criminal boss suspected of involvement in the attempted raid on La Ferme (see above), allegedly had a role in the Agrolinda takeover as well.⁸⁷

Ernesto Preatoni, a wealthy Italian businessman who later gained Estonian citizenship, along with Ilona Saari, a board member at his Pro Kapital Group, were reportedly involved in various shady dealings with Veike, Arakas, Jõgi, and the others (more on Preatoni, as well as Veike, Arakas, and Jõgi, below).⁸⁸ In 1998, Veike was killed by machine-gun fire outside of Vasara, another real-estate holding company, after a dispute with Arakas about the takeover of Vasara's properties.⁸⁹ Because Agrolinda and Vasara are both real estate companies, as is La Ferme, they do not increase the sector count.

While La Ferme, Flora Vara, Agrolinda, and Vasara were the only raids I was able to confirm, various respondents mentioned a handful of other cases I could not confirm. One pointed to the transit trade during the early 1990s, when strong-armers occasionally hijacked shipments on the roadways and tended to settle scores through violence. Although tiny, the land on which Estonia sits occupies an important geographical position in the transport of goods from northern Russia to the Gulf of Finland and the Baltic Sea. Given its geography and the fact that former KGB officers were prominently involved in the transit trade, the violence that characterized it should come as no surprise.⁹⁰

The trade in rare earth metals was particularly notorious for its violence. During this early 1990s Estonia became one of the world's largest exporters of rare earth metals. Imre Arakas, who appeared in several of the raids above (and is a former classmate of Mart Laar's) was at one point wanted by police for a bomb attack on a rival criminal group. His grievance at least in part stemmed from a contested metal shipment. Another violent episode occurred when a news story on the theft of fuel from an oil terminal resulted in the shoot-up of someone's car. By the mid-1990s, Estonian authorities had successfully clamped down on the trade and driven out the criminal element.⁹¹

Respondents mentioned another possible raid, also in the transportation and warehousing sector (although without the violence that characterized the above-referenced cases). However, I could not obtain enough details either from my sources or news reports to confirm that it was indeed a raid.⁹² If this and the other transportation-sector cases mentioned above are to be considered actual raids, they would have no

⁸⁷ Ibid; Raidla & Jakobson, "Rünnaku Luige vastu..."

⁸⁸ "Saari elukaaslane 'tõmbas mütse pähe'," *Äripäev*, 1 August 2001 (<http://arileht.delfi.ee/news/uudised/saari-elukaaslane-tombas-mutse-pahe.d?id=1824315>).

⁸⁹ Non-Plutocratic Raid #4. Raidla & Jakobson, "Rünnaku Luige vastu..."

⁹⁰ Interview with Mihkel Kärmas, 22 October 2008.

⁹¹ Ibid.

⁹² Interviews with Respondents #91, 92, and 93.

impact on the total sector count; the raid on Flora Vara also belongs in the transportation and warehousing sector and has already been noted.

In addition to these cases, my respondents also brought up a bank and insurance company that allegedly hauled their clients into bankruptcy court under shady circumstances.⁹³ However, they could offer neither names nor other details sufficient to confirm the cases as bona fide raids.

What effect the inclusion of the above cases would have had on the sector count is unknown as I cannot determine which sectors were involved. Regardless, Estonia is distinct in one key respect. In the other three countries, too, there were plenty of questionable cases like these that I could not include in the sector count due to insufficient information. All the same, I had no problem finding plenty of other raids that I *could* confirm – more than enough, in fact, to cover most of the sectors (those sectors in which I did not find raids were generally ones that make up a small portion of the overall economy, thus making it less likely I could identify any raids in the first place). Not so in Estonia; while the disputable cases cast some uncertainty over the final sector count, there were hardly enough definite raids to compensate for this uncertainty and enable me to obtain a higher count. In terms of the frequency of non-plutocratic raiding, Estonia clearly stands apart from Poland, Slovakia, and Ukraine.

Kantimine

There are, however, numerous cases where assets changed hands under suspicious circumstances but which nevertheless do not qualify as criminal corporate raids. Jaak Veike and his partners (who were involved in the raid on Agrolinda above) allegedly falsified documents stating that they owned privatization vouchers in a number of companies including Tallinna Kaubajama and the Saku Brewery. They then attempted to sell the vouchers. But these episodes did not require the assistance of an agent of force and so cannot be considered attempted raids.⁹⁴ Along with his partner, Ahti-Kullervo Jõgi, Veike also bought up financially-distressed companies and tunneled their real estate assets (valued at a relatively paltry EEK2.2 million) to an offshore company. With the exception of Agrolinda, however (see above), no agent of force was involved.⁹⁵

Estonians refer to this phenomenon as *kantimine*. *Kantimine* denotes stripping the assets of one company and transferring them to an outside entity (the technical legal term is *ettevõtte üleminek*, or “transfer of an enterprise”). In 2004, prosecutors accused Jürgen Jervik of illegally transferring assets from Revalhaus Kinnisvara OÜ, a real estate developer he jointly owned with Arvo Klaas. Jervik allegedly tunneled the company’s property through one-sided deals with outside firms he controlled.⁹⁶ In another case, the Supreme Court ruled in 2005 that NG Investments (NG Investeeringud) cheated minority shareholders in Liviko, a beverage maker, when it acquired the company. Again, however, the incident did not feature an agent of force while the amount in question was a relatively small fraction of the shareholders’ equity stakes.⁹⁷ Ernesto Preatoni, the

⁹³ Ibid.

⁹⁴ Interview with Hans Luik, 24 October 2008.

⁹⁵ “Corporate raider’s tax problems,” *Äripäev*, 23 May 2001.

⁹⁶ Correspondence with State Prosecutor Andrei Voronin, 24 September 2008 and 8 December 2008.

⁹⁷ “Court forces investor to fork over more funds for Liviko,” *The Baltic Times*, 16 November 2005.

wealthy Italian businessman who was allegedly had dealings with Veike and Arakas, came under fire in 2001 for allegedly bilking other shareholders in his Pro Kapital group. This was after Pro Kapital reportedly purchased substantial real estate holdings from Preatoni at above-market prices, resulting in losses for the other owners.⁹⁸

A frequent method used to carry out *kantimine* is to hold an illegal board meeting without giving sufficient notice to other shareholders, changing the management, and then stripping the assets. “The criminal would go to the local government office to present the (false) signatures on the decision of the shareholders to change the board members, submit the papers to the business register, go to the bank, and empty the bank account or open a new one,” explains Kristel Siitam-Nyiri, a state prosecutor. “In some cases the owners didn't even discover it until they couldn't use the bankcard or some journalist called them. The Ministry of Justice reacted quickly and now the business register electronically notifies all board-members about any change in the register.”⁹⁹

This is a common tactic we have already seen in the other countries. The difference in Estonia is that changes to the composition of supervisory or management boards do not require the authorization - and, thus, collusion - of a judge; all that is necessary is for an unsuspecting municipal clerk to sign off on the change. If it were actually imperative to bribe an agent of force (which a judge is), illegal board meetings would be non-existent in Estonia. This simple reason is that attempting to pay off a judge is generally a far riskier proposition in Estonia. However, under Estonian law the intervention of an agent of force is unnecessary, and it is only this fact that renders *kantimine* at all common. Typically, it is used only by low-level criminals seeking to steal from small businesses, usually single-member limited liability companies.

Carlos Antonio Leon Montero, owner of Baltic Resurs OÜ, a caterer and restaurant planner, was the victim of this form of *kantimine*. “I discovered the deception accidentally,” Montero says. “I wanted to pay for a purchase with my company's card, but it came out that the card had been closed. At the bank I found out that some guy named Jürisoo had become a member of the management board instead of me. He had closed out the company's old account and opened a new one.” Montero solved the problem by doing to the criminals exactly what they had done to him - going to the local Commercial Registry Office and reappointing himself to the board. Two small-time criminals were responsible for a spate of such illegal board meetings in 2008. One was Ergo Ivanov, a 26-year-old with eight years of formal education and a prior conviction for stealing alcohol from a warehouse. Another, Jevgeni Moskaljov, had recently finished a prison stint for theft, blackmail, and document infringement.¹⁰⁰

These are precisely the types of criminals who might have become prominent political thugs had they been operating in Poland, Slovakia, or Ukraine. Yet in Estonia it is far more difficult to forge the extensive political connections needed to take their businesses to the next level. As a result, would-be political thugs typically remain

⁹⁸ Inno Tähismaa, “Preatoni lai haare võib saada tagasilöögi,” *Äripäev*, 16 July 2001 (http://ap3.ee/Default2.aspx?PaperArticle=1&code=1962/uud_uudid_196201); “Saari elukaaslane “tõmbas mütse pähe.”

⁹⁹ Correspondence with Kristel Siitam-Nyiri, 16 September 2008; Koit Brinkmann, “Petturid trügivad firmade juhatusse,” *Äripäev*, 7 May 2008.

¹⁰⁰ Brinkmann, “Petturid trügivad firmade juhatusse.”

ordinary thugs, deprived of the chance to make it big through soft-budget constraints and criminal corporate raiding.

A rare case of large-scale *kantimine* followed the June 2007 death of Siim Mesila, one of Estonia's most successful real estate developers. Among his most important holdings was Torm Projekt, which he co-owned with his two partners, Meelis Rae and Andres Samarüütel. Mesila controlled 50 percent while the other two partners held 25 percent each. Shortly after his death, documentation was submitted to the local Commercial Registry Office. The documents showed that, several days before Mesila's passing, a board meeting was held at which new share capital was raised. As it happened, Mesila was not present at the meeting to buy any of the new shares, which would have avoided the dilution of his 50-percent stake. (Estonian law at the time allowed meetings to occur without the presence of all shareholders if repeated attempts had already been made to notify the missing shareholder.) Consequently, Mesila's share of Torm Projekt declined to a mere 20 percent while his partners ended up with 40 percent each. Journalist Sulev Vedler believes that Rae and Samarüütel actually held the meeting after Mesila's death, not beforehand as they claimed. The goal, Vedler suggests, was to reduce the size of the stake that was to be inherited by Mesila's wife and legal heir. When questioned by the journalist, the two partners expressed outrage that he would stir up trouble for the grieving family at such a difficult time. "We hope that you, as a journalist, will respect the memory of the departed and that you will not try to put together a piece of yellow journalism based on insinuations," they expressed in a fit of self-serving, *faux*-indignation. "As a good journalist you will surely find a more interesting topic to write about."¹⁰¹

Another case of *kantimine*, noteworthy for the substantial assets involved, targeted T.R. Tamme Auto, owned by Raivo and Toomas Tamm, one of Estonia's wealthiest families. In the summer of 2008, a criminal by the name of Ats Nõmm presented false documents to a notary and the Commercial Registry Office claiming that he had been appointed CEO. The notarized documentation enabled him to withdraw EEK150,000 from T.R. Tamme's bank account at Hansapank. An attempt to do the same at another bank raised suspicions among bank employees, who phoned the owners and went to the police.¹⁰² Nõmm's arrest followed and he was convicted in November 2010.¹⁰³

"In Estonian commercial law there is nothing that says you can't hold a shareholders meeting at 2 am in the Canary Islands," says Anton Sigal, a lawyer. Even then, this type of asset-stripping must be accomplished very quickly since the victimized shareholder can rely on an honest and well-functioning judicial system to get any fraudulent decisions reversed.¹⁰⁴ Moreover, my respondents balk at the notion that a private security team would ever be used by the criminals to escort the new management into place, as Poland's Zygmunt Solorz did at Elektrim or innumerable Ukrainian political thugs routinely do to this day. In any event, the practice of illegal board

¹⁰¹ Sulev Vedler, "Kinnisvarahai salapärase surm," *Äripäev*, 21 June 2007.

¹⁰² Ingmar Muusikus, "Noor petis kaaperdas miljonäride suurfirma," *Eesti Ekspress*, 21 August 2008 (<http://ekspress.delfi.ee/news/paevauudised/noor-petis-kaaperdas-miljonaride-suurfirma.d?id=27680449>); Interview with Toivo Tänavsuu, 30 October 2008.

¹⁰³ Toomas Herm, "Arvutikelmid hõivasid äriühingu," *Virumaa Teataja*, 17 November 2010 (<http://www.virumaateataja.ee/343028/arvutikelmid-hoivasid-ariuhingu>).

¹⁰⁴ Interview with Anton Sigal; Interview with Tarmo Vahter.

meetings was largely eliminated from existence with a modification to the law. Under the new rules, board meetings require the attendance of all shareholders while meetings resulting in a change to the board must be attended by a notary (“no, you can’t bribe the notary,” says Katrin Prükk).¹⁰⁵

Kantimine in the sphere of bankruptcies has presented a special problem in Estonia. As of the end of 2008, doubts arose in approximately ten percent of cases over whether a given bankruptcy was legitimate or instead a ruse to illegally transfer assets out of the firm, according to legal specialist Merike Varusk. A typical practice is for one or more owners of a company to move the assets to an outside entity while leaving the old structure saddled with the liabilities. The goal is to escape the firm’s creditors. The task is relatively simple: register the new entity on the internet, lay off the employees (who now receive welfare payments from the employment board), re-hire the employees in the new entity (usually under-the-table), and conclude new contracts with clients. Sometimes the company’s name is slightly altered. But the equipment, employees, and business premises remain the same.¹⁰⁶

In another scheme, the owner of the debtor firm sets up a separate entity that issues a trivial loan to the company. The new creditor is then able to veto the claims of all other creditors. The latter find themselves faced with the unpleasant choice of either going to court or negotiating a deal with the debtor. This happened at Viru Rand in 1998, when a tiny liability-holder showed up at a creditors’ meeting and vetoed every last claim. One of the victimized creditors was Hansapank, which was owed EEK70 million. Attempting to resolve the situation, it deposited into the troublesome creditor’s bank account the marginal sum it was owed. But the creditor simply returned the money and continued with its disruptive efforts. In the end, Hansapank had to compromise; it turned out that some the documents required to prove its claim were not entirely in order, thus leaving the bank in a vulnerable position in any ensuing court battle.¹⁰⁷ This sort of scheme was legislated out of existence by the 2001 Law of Obligations, which enabled judges to rule on the basis of broad legal principles rather than the strict letter of the law.¹⁰⁸

Another method debtors use to evade creditors proceeds as follows. The debtor firm sets up a new company which extends a large loan to the debtor. The loan is sufficiently big to ensure that the fake creditor represents at least 55 percent of the votes and two-thirds of the debt in any bankruptcy. This is the minimum required under the law for a compromise between a debtor and its creditors to take effect. The fake creditor - typically an offshore company with untraceable ownership - then negotiates a “compromise” with the debtor firm that is highly favorable to the latter (e.g. by greatly reducing the amount owed and/or the time required to pay down the debt). An example was Alexela Oil, a petrol-station operator which filed for bankruptcy in 2002. An offshore company sprouted out of nowhere to issue a loan to Alexela worth EEK100 million. After this, a “compromise” was duly reached which reduced the claims of the real creditors to five cents on the dollar. The deal technically complied with the letter of

¹⁰⁵ Interview with Katrin Prükk, 7 October 2008.

¹⁰⁶ Interview with Merike Varusk, 24 September 2008.

¹⁰⁷ Interview with Katrin Prükk, 7 October 2008.

¹⁰⁸ Ibid.

the law, thus precluding any move by the bankruptcy court to prevent it from entering force. Parliament changed the law in 2006 to eliminate this scam.¹⁰⁹

As with illegal board meetings, none of the above schemes involved the collusion of an agent of force, like a bankruptcy judge or trustee, to help seize the assets. As such, they do not qualify as raids. All of the bankruptcy officials and lawyers I consulted in Estonia flatly deny that bankruptcy judges or trustees can be bribed.¹¹⁰ This state of affairs did not arise by accident. Had there existed legions of political thugs seeking to corrupt state officials, Estonia's bankruptcy judges, trustees, and other agents of force might have found it harder to avoid succumbing to their illicit overtures. This would have been especially true during the 1990s, when state officials were particularly vulnerable to bribery due to low pay. Had illicit payoffs to bankruptcy officials become the norm in those years, as it did in the other three countries, it may indeed have proved difficult to root out later on. Estonia, however, lacked the large population of predatory business actors that spawned in Poland, Slovakia, and Ukraine. As a result, there were relatively few such individuals attempting to bribe the state's agents of force in the first place. This created an environment in which sound property rights institutions could develop and take root. Law-enforcers were free to focus their attention on the relatively few cases of bribery that did occur. Moreover, to the extent that a cultural norm of honesty and professionalism did not yet exist among civil servants, it had room to develop. To the extent that did exist already, it could remain in place instead of disintegrating under the weight of constant solicitations by corrupt business actors.

One might object to differentiating bankruptcy-*kantimine* in Estonia from similarly fraudulent bankruptcies observed in the other countries. After all, the creditor is getting cheated out of its assets either way. Surely, from the creditor's standpoint, it matters little whether the bankruptcy judge is colluding with the debtor or the debtor is instead acting on its own.

It may indeed be irrelevant to the individual creditor but, from the standpoint of society as a whole, it is highly consequential indeed. When economic predators can easily conspire with the state's agents of force, this places all creditors in great peril. Where such collusion is impossible, siphoning assets through bankruptcy- and related schemes becomes all the more difficult to achieve and likely rarer as a result.

For this very reason, one does not see the kinds of artificial bankruptcies observed in Slovakia during the heyday of "bankruptcy specialist" Zoroslav Kollár. To recall, these takeovers involved purchasing a trivial liability owed by an otherwise healthy company, preventing the latter from repaying the debt, and cooperating with a bankruptcy judge and trustee to liquidate the firm. One explanation for its absence in Estonia is that the law is structured in such a way as to prevent such abuses; in contrast to Slovakia, the court cannot initiate an insolvency proceeding without the satisfactory completion of a preliminary meeting between the debtor and creditor. The fact that the creditor must meet the debtor face-to-face gives the debtor a chance to pay what is owed. This forestalls any attempt by a predatory creditor to deliberately prevent repayment and force the debtor into liquidation.¹¹¹

¹⁰⁹ Ibid.

¹¹⁰ Ibid.; Interview with Merike Varusk, 24 September 2008.

¹¹¹ Interview with Katrin Prükk, 7 October 2008.

Nevertheless, the law mandating preliminary meetings took effect only in 1997. Before that, it would have been theoretically possible to initiate artificial bankruptcies of the kind seen in Slovakia.¹¹² But a number of bankruptcy experts I consulted could recall no such cases. The reason, this study suggests, is that the political thugs with a clear interest in engineering such takeovers have had a relatively marginal presence in Estonia. Sound laws are nice, but an absence of the economic predators who seek to manipulate them is even better.

A further illustration of this point came during the financial crisis of 2007 to 2009. Despite the improvements in bankruptcy law over the preceding decade, bankruptcy-*kantimine* made a comeback; as is often the case when there is a sufficient motive, business actors facing mounting liabilities found new ways to get around the law in order to evade creditors. Some of these methods were technically legal. Others were illegal but tended to go unpunished since Estonia lacks enough investigators with the qualifications to pursue them. The Prosecutor's Office publicly admitted that illegal asset-transfer schemes were not one of its priorities; it lacks the funds and specialized personnel to investigate such cases and they are difficult to prove as well.¹¹³

This dilemma is typical to any early capitalist society; even though Estonia has made much progress in the development of its property rights institutions, it remains a young market economy and still has considerable work to do. In this context, it is not so much the integrity of the law or availability of law-enforcers that determines the frequency and scale of asset-stripping schemes. It is rather the collective strength of those actors with an interest in deploying them. Where predators of this sort exist in large numbers, such property-rights violations are likely to be widespread and severe. Where they do not, the abuses should be rarer and less harmful.

The Plutocratic Elite

As we have seen in previous chapters, former communists are more likely on average to end up as political thugs than are businesspeople hailing from other segments of the population. In Estonia, however, the ability of political thugs to access fraudulent privatizations and other soft budget constraints was relatively limited. This meant that few ex-communists could make it to the very top of the Estonian business elite (Table 7.1).

All the same, many former communists did go into business and some even became prominent, although few of them can be considered political thugs. The most well-known ex-nomenklatura businessman is Indrek Toome, the former communist-era Prime Minister, who went into the real estate and hotel business. He has done well despite having once been prosecuted for bribery (he was acquitted of the charges in 1995).¹¹⁴ Another notable ex-communist is Tiit Vähi, who has also achieved noteworthy success. He became famous for privatizing Silmet to himself when he was Prime Minister in a rare case of privatization fraud. Jüri Kraft, a former minister of light

¹¹² Ibid.

¹¹³ Ibid.; Interview with Merike Varusk, 24 September 2008; Interview with Respondent #108.

¹¹⁴ Interview with Respondent #107; Interview with Sulev Vedler, 18 September 2008; "Ex-Premier Acquitted," *The Moscow Times*, 17 March 1995 (<http://www.themoscowtimes.com/news/article/ex-premier-acquitted/341562.html>).

industry in the communist period, owns Sangar, a successful clothing manufacturer that produces garments for major international retailers. He had served as chief executive of the company for a brief period before the Soviet collapse. Rein Sillar, the last head of the Estonian KGB, went into the murky metals business in the early 1990s with another former communist, Tiiu Silves. Sillar later branched out on his own while Silves went bankrupt.¹¹⁵

Another prominent ex-communist is Ants Laos, who became a shareholder in Viru Keemia alongside plutocrats Priit Pillmann, Margus Kangro, and Elar Sarapuu.¹¹⁶ Rein Kaarapere, a former member of the Soviet-era Council of Ministers, founded the Tartu Commercial Bank in 1988 with the help of his communist connections. It eventually failed and was shut down by the central bank. Kaarapere later joined Hansapank, where he was the lone ex-communist among the senior management.¹¹⁷

With a few notable exceptions, however, most former communists who tried their hand in business did not make it into the ranks of Estonia's richest. Those who won privatizations were generally unable to transform their companies into star players on the business scene, according to Peeter Raidla, one of Estonia's most knowledgeable investigative journalists. "There are some examples of 'red directors' in business, but none managed to take their businesses to the next level," he says.¹¹⁸ "The major obstacle for the guys from the communist party who went into business was that they were very good at conducting business locally but were not so great at taking their businesses onto international markets," according to Aavo Kokk. "The younger people here are much smarter. And that's why those from the younger generation tend to be the ones among the very rich." Former communists, Kokk explains, may have had some advantage in the privatization process to the extent that had some familiarity regarding which companies were truly valuable. "But not all of them were able to run these companies well," he adds.¹¹⁹ And that is precisely the point: in an environment of soft budget constraints, running one's company well would not have mattered. But in Estonia, ex-communist businesspeople by and large had to deal with the same competitive conditions faced by other business owners.

A small handful did make it into the plutocratic elite, although none are political thugs. In the 1990s, Fjodor Berman privatized a large stake in Baltic Ship Repairers (BLRT), the same company he had directed for two decades. Together with his partners, fellow plutocrats Mikhail Gnidin and Valeri Kovalenko, he has since turned it into an

¹¹⁵ Peeter Raidla, "Silvese välisfirmade aastakäive 6 miljardit," *Äripäev*, 15 March 2011

(<http://www.Äripäev.ee/default.aspx?publicationid=31503ED6-39D4-4163-9D98-74AA1E3959CE&code=115662>), Kirsti Vainküla, "Tiiu Silves alustab uut elu," *Õhtuleht*, 30 March 2005 (<http://www.oh tuleht.ee/171987/tiiu-silves-alustab-uut-elu>), Mihkel Kärmas, "Tallinna Tuhkatriinu suured kingad," *Eesti Ekspress*, 16 August 1996 (<http://blog.ekspress.ee/Arhiiv/Vanad/1996/33/magnet.html>); Marko Liibak, "Endine KGB kindral Rein Sillar: Olen väsinud olemast tont," *Õhtuleht*, 15 December 1999 (<http://www.oh tuleht.ee/67683/endine-kgb-kindral-rein-sillar-olen-vasinud-olemast-tont>).

¹¹⁶ Aivar Hundimägi, "Rikaste TOP: Põlevkiviõliga kauplejaid jälitab minevikutaak," *Äripäev*, 15 March 2011; Interview with Sulev Vedler, 18 September 2008.

¹¹⁷ Interview with Enno Tammer, 5 November 2008; Aavo Kokk, Tarmo Vahter & Priit Vare, "Varakapitalismi sümboli lahkumine," *Eesti Ekspress*, 16 January 1997 (<http://blog.ekspress.ee/Arhiiv/Vanad/1998/03/nekroloog.html>).

¹¹⁸ Interview with Peeter Raidla; "Sangar elects new council chairman," *Baltic Business News*, 18 March 2002;

¹¹⁹ Interview with Aavo Kokk.

enormously successful conglomerate and is consistently ranked among the five wealthiest Estonians.¹²⁰ Unlike in Poland, Estonia's shipbuilding sector is not subsidized by the state. As a result, BLRT had to make its way in the world without government support. However, both Berman and BLRT have recently faced various accusations of malfeasance. In particular, Gnidin accused Berman and his son, Mark, of gifting themselves BLRT shares at low prices without the approval of other shareholders. Another shareholder, Oleg Oikimus, filed suit against Mark Berman for allegedly cheating him out of his shares. A municipal government took a BLRT subsidiary, BLRT Laevaehitus, to arbitration court over the latter's failure to pay a penalty for the late delivery of a vessel it had constructed for the municipality. Before the payment could be collected, BLRT Laevaehitus went bankrupt. The bankruptcy trustee accused BLRT Laevaehitus of transferring the required funds to another company while the arbitration case was still pending.¹²¹

Väino Kaldoja, another plutocrat, was the manager of a large auto park during Soviet times. Its cars serviced important government ministers and other VIPs. After the Soviet collapse, he capitalized on his good connections with Mercedes Benz and founded Silberauto, which became the sole authorized Mercedes dealer in Estonia. He is generally regarded as an honest businessman.¹²²

Unlike in Ukraine and Poland, none of the individuals on the list of wealthiest Estonians, including Berman and Kaldoja, accumulated significant wealth during the communist period. The most common route to success for the plutocrats was the privatization process. "In hindsight, many of the prices look ridiculous," says Mihkel Kärmas, an investigative journalist. But, he adds, that was not necessarily a bad thing; the sales contracts stipulated steep investment obligations with which the buyers had to comply.¹²³

Political Thugs

The remarkable thing about Estonia's political thugs is that, upon closer inspection, many do not really look much like political thugs. Some have moved on from shady beginnings to invest in profitable businesses. Others, even though they scored their early successes through rent-seeking, did not do so with the collusion of the state's agents of force. The typical political thugs seen in the other three countries built their first fortunes using political connections to secure massive soft budget constraints. Due to the hard budget policies of Estonia's early post-communist governments, classic political thugs of this type would, with very few exceptions, rarely end up rising to the very top. The following will detail who these individuals are along with any raids in which they allegedly had roles. The few Estonian plutocrats who have been linked to such activities are precisely the ones whose beginnings most resembled those of standard political thugs.

¹²⁰ Interview with Peeter Raidla; "Eesti Rikaste Top 500," *Äripäev*, October 2011.

¹²¹ Anastasija Tido, "BLRT skandaalide keerises," *Äripäev*, 7 May 2013 (<http://www.Äripäev.ee/default.aspx?publicationid=31503ED6-39D4-4163-9D98-74AA1E3959CE&paperarticleid=a874d0cb-0fc1-4a50-86ae-fddeda9db190>).

¹²² Interview with Peeter Raidla, 17 November 2008; Interview with Sulev Vedler, 18 September 2008; Toomas Hõbemägi, "Car dealerships – the pride of Estonian capitalists." *Baltic Business News.com*, May 6, 2002.

¹²³ Interview with Mihkel Kärmas, 22 October 2008.

Table 7.9. Alleged Plutocratic Raids

<u>Raid #</u>	<u>Target</u>	<u>Alleged Perpetrator</u>	<u>Pol. Thug?</u>
1	Companies held by Hansapank shareholders	Hands Schmidt; possibly Pant and Järvelill	Y
2	Estonian Railways	Ossinovsky	Y

Table 7.10. Alleged Plutocratic Raids: Confirmation Indicators

<u>Indicator #</u>	<u>Indicator Key</u> <u>Description</u>
1	Many domains
2	Spontaneous public actions
3	Unrelated offenses
4	Non-existent laws
5	Suspicious bankruptcy / redistribution
6	Repeated investigations/prosecutions
7	State action in midst of political conflict
8	Direct force
9	Threats made
10	State actions ruled (or suspected to be) illegal
11	Target is a rival of powerful interests
12	#2, 8, or 9 coincides with state action
13	Illegal board meeting

<u>Raid #</u>	<u>Target</u>	<u>Alleged Perpetrator</u>	<u>Indicators</u>													<u>Substantiated?</u>		
			1	2	3	4	5	6	7	8	9	10	11	12	13			
1	Companies held by Hansapank shareholders	Hands Schmidt; possibly Pant and Järvelill													X			Y
2	Estonian Railways	Ossinovsky												X	X	X		Y

This fact underscores the contention of this study that only political thugs and not actors of the other two types tend to engage in criminal corporate raiding. Tables 7.9 and 7.10 list the various plutocratic raids I uncovered along with the raiding indicators present in each case.

Priit Pillmann, Margus Kangro, Elar Sarapuu, and Ants Laos own Viru Keemia Group, an oil shale producer. They scored their early success by swindling the state in the bankruptcy of Eriõli, another oil company. Pillmann and Sarapuu privatized Eriõli in the early 1990s. It proceeded to go into bankruptcy before they had finished paying off the contract. Viru Keemia, an offshore entity they had established in Belize during the bankruptcy, swooped in and bought up the best assets of Eriõli at knockdown prices. This potentially placed Ühispank, Eriõli’s main creditor, in danger of not receiving its money back.¹²⁴

¹²⁴ Interviews with Peeter Raidla, Sulev Vedler, Toivo Tänavsuu.

However, Viru Keemia struck a deal with the bank, represented at the time by Margus Kangro, its then-director of distressed debt. Under the terms of the agreement, Ühispank would receive most of its money back. But it would do so mainly thanks to a tax-avoidance scheme that cheated the state out of its money. As a result of Kangro's help, Pillmann and Sarapuu gave him a stake in Viru Keemia worth approximately EEK2 billion (in exchange for the nominal sum of EEK10,000-15,000). It was through this "strange process of *kantimine*," as Peeter Raidla describes it, that the three businessmen first made their way into the ranks of Estonia's wealthiest. (It was not a raid, however, as the only victim was the state.) Although they only managed to establish Viru Keemia through soft budget constraints, they have since built it up into a successful company, greatly expanding its size in the process.¹²⁵

Although he did not rely on coercive resources to obtain his fortune, Marcel Vichmann, a lawyer by training, certainly benefited from soft financing from his employer, Eesti Hoiupank (Estonian Savings Bank), where he served as chief counsel. In 1997, Hoiupank was planning an emission of new shares on the stock exchange. The market subsequently collapsed, taking with it the bank's stock price. Vichmann, along with five other bank officials, formed a joint-stock company to purchase the new shares at the prevailing low prices. To finance the purchase, they took out a loan from a foreign bank. In most countries, including Estonia, few banks issue loans for the purpose of financing the purchase of stock; in the event of bankruptcy, the holders of loans receive preference over the owners of stock, but if money from the loan is used to purchase stock, that money will disappear if the debtor goes out of business. The fact that they financed their acquisition of Hoiupank stock using a bank loan was not the only questionable part of the deal; it turned out that the Hoiupank officials arranged for Hoiupank itself to guarantee the loan in case of default.¹²⁶

Hoiupank later went under and was acquired by Hansapank, which discovered - to its great displeasure - that Vichmann and his partners were now shareholders in the bank (due to the stake they had previously purchased in Hoiupank). Hansapank responded by taking the consortium-members to court. Five of the six beneficiaries of the questionable stock purchase chose not to contest the suit. But Vichmann remained adamant that they had acted within the law. He fought the case and eventually won; the court found no technical violation of the rules. Thanks to this clever maneuver, he became one of Estonia's wealthiest people.¹²⁷

Because Vichmann likely did not collude with any agent of force in this process, he probably fails to qualify as a conventional political thug. Surely, though, it was not by creating any real economic value that he secured his fortune.

Another suspicious transaction involving Vichmann - and which did make use of a public official - concerned the privatization of the passenger rail arm of Estonian Railways. A former classmate of Vichmann's, Tiit Pruuli, worked as a lawyer at Estonian Railways at the time that it was preparing the privatization. The contract was

¹²⁵ Interviews with Peeter Raidla, Toivo Tänavsuu.

¹²⁶ Interviews with Peeter Raidla, 10 November 2008 and 17 November 2008; Interview with Mihkel Kärmas, 22 October 2008.

¹²⁷ Ibid.

awarded to Go Grupp, a company owned by Pruuli and Vichmann. “So [Pruuli] was preparing the privatization of this Estonian Railways arm to himself,” Raidla explains.¹²⁸

Toonart Rääsk is a likely candidate for a political thug but his origins remain sufficiently mysterious to forestall any definitive conclusion in this regard. A lawyer by training, he came into ownership of substantial properties very suddenly during the mid-1990s. Among these is the Metropol Hotel. “How can you become so rich, starting from nothing, in so short a time?” Raidla asks incredulously. Rääsk was generally considered an underworld figure and had a reputation for maintaining links to shady operators (although he is now regarded as a reputable businessman). When he constructed a hotel in Tallinn, he allegedly obtained the necessary permits after the fact rather than beforehand, the law requires. He also escaped an investigation by tax officials thanks to an “accidental” fire at one of his offices which happened to destroy his company’s accounting files.¹²⁹

The plutocrats considered thus far have not been connected to any raids. This is not so for (at least some of) the individuals around Tallink, a shipping operator. In the mid-1990s, Enn Pant served as second-in-command at the Ministry of Finance and concurrently as Chairman of state-owned Estonian Shipping (Eesti Merelaevandus). Estonian Shipping held a stake in Hansatee, a financially-troubled ferry operator. Pant took on the job of fixing Hansatee and eventually received a shareholding in return. But the firm only emerged from bankruptcy thanks to Pant’s friend Kalev Järvelill, the Tax Board chief, who agreed to defer its tax arrears. Järvelill would himself receive a major chunk of Hansatee.¹³⁰

The only problem, as far as Pant and Järvelill were concerned, was that they were not the only shareholders in Hansatee; Estonian Shipping also held a significant stake. The matter was settled after Pant and Järvelill tunneled Hansatee’s assets out of the company and into a new entity they had formed for this very purpose. That entity was Tallink. It was through this asset-stripping scheme that the two partners deprived the state of its holdings and became the exclusive owners of Hansatee’s choicest pickings. Pant owned two-thirds of Tallink with the remaining one-third belonging to Järvelill.¹³¹

In addition to the tax deferral from Järvelill’s Tax Board, Hansatee would have never have made it out of bankruptcy if not for Ain Hanschmidt, head of Ühispank, which provided the financing. Officially, Järvelill and Pant were the only shareholders in Tallink. However, shortly before the company’s IPO in 2005, Pant’s official stake, as it was listed in the Commercial Register, suddenly declined by half. The owner of the other half turned out to be an obscure firm by the name of Abante, headed by Hare Reig, Hanschmidt’s lawyer. A sensational newspaper story by Peeter Raidla exposed this fact. It also revealed that Pant had sold the Tallink shares to Abante for 0.01 percent of their true value. Shortly thereafter, Reig in turn sold his stake in Abante to Hanschmidt.

¹²⁸ Interview with Peeter Raidla, 10 November 2008.

¹²⁹ Interviews with Peeter Raidla, 10 November 2008 and 17 November 2008; Interview with Mihkel Kärmas, 22 October 2008; Interview with Sulev Vedler, 18 September 2008; Toomas Hõbemägi, “Wealth of 500 Estonia’s richest businessmen down to 111 billion kroons,” *Baltic Business News*, 24 September 2010 (<http://balticbusinessnews.com/default.aspx?PublicationId=3911008c-5268-40fb-9894-2f3a62a126f7>).

¹³⁰ Interviews with Peeter Raidla, 10 November and 17 November 2008; Interview with Sulev Vedler, 18 September 2008.

¹³¹ Ibid.

Unless Pant deliberately set out to deprive himself of billions of kroons, the circumstances strongly suggest that Hanschmidt had actually held his stake in Tallink all along - even while ensuring its continued financing in his role as boss of Ühispank.¹³²

Unlike the political thugs or near-political thugs covered thus far, Hanschmidt is the only one whose name has been associated with criminal corporate raiding. In 1999, Aivar Sõerd was appointed as head of the Tax and Customs Board. While serving in this post, he had the agency pursue a number of individuals linked to Hansapank, Estonia's largest bank, for alleged tax evasion.¹³³ The persons targeted included Tiina Mois, Hansapank's chief accountant, along with shareholders Rain Lõhmus and Tõnis Palts. Upon his appointment as Finance Minister in the 2003 elections, Palts summarily sacked Sõerd, thus ending any investigation. According to my sources, Sõerd's pursuit of Hansapank's owners was part of a campaign to force them to hand over stakes in their private companies to principals at Ühispank. They had already refused previous offers for these stakes. But Sõerd's attack upped the ante; "these were offers they couldn't refuse," as fellow plutocrat Hans Luik describes it. At the time of the tax investigations, Ühispank was led by Hanschmidt, the future Tallink shareholder alleged to have secretly held his Tallink shares while at Ühispank. Were any of the other Tallink shareholders involved in the attack on Hansapank's owners? It is difficult to say, but Sõerd, the tax official who led the charge, was later given a plush job at Tallink.¹³⁴

Nevertheless, these sorts of raids are not common in Estonia, my respondents insist. "What happened at Hansapank was a rare thing," according to Luik. His view is shared by attorney Peeter Lepik; "this kind of thing doesn't happen anymore."¹³⁵

In addition to raiding, some of Tallink's owners have been linked to harassment of another type. In 2006, they caused a scandal for their outrageous behavior on board one of the company's ferries. They reportedly threatened to sack the entire crew for attempting to restrain the riotous party. Pant, for his part, was accused of sexually molesting a male attendant.¹³⁶

Thanks in large part to Pant's efforts to restructure and improve its assets, Tallink has since become one of Estonia's most successful companies, attracting financing from major international players such as Citigroup. For this reason, Pant is classified here as a crony capitalist rather than a political thug. As for his partners, it is not clear what, if anything, they contributed to Tallink's success other than their political access – hence their designation as political thugs.

The final political thugs to consider made their fortunes from soft budget constraints in the transit business. Anatoli Kanajev rose to wealth not through grit and

¹³² Ibid.

¹³³ Plutocratic Raid #1

¹³⁴ Raimo Poom, "Estonia: Sacking the Taxman," *Transitions Online*, 22-28 July 2003; Interview with Hans Luik, 24 October 2008; Interview with Peeter Lepik, 3 November 2008; "Aivar Soerd appointed the managing director of Tallink Hotels," *Baltic Business News*, 9 May 2007 (http://www.balticbusinessnews.com/article/2007/05/09/Aivar_Soerd_appointed_the_managing_director_of_Tallink_Hotels).

¹³⁵ Interview with Hans Luik, 24 October 2008; Interview with Peeter Lepik, 3 November 2008.

¹³⁶ "Sweden hands investigation of alleged assault by Tallink executives to Finland," *Baltic Business News*, 21 December 2006 (http://www.balticbusinessnews.com/article/2006/12/21/Sweden_hands_investigation_of_alleged_assault_by_Tallink_executives_to_Finland).

hard work but rather his position as head of the Port of Tallinn. His role gave him access to at least one very lucrative soft budget constraint; appointed to the post in the early 1990s, his wife was granted a shareholding in Pakterminal. Thanks to favorable decisions by Kanajev, Pakterminal became one of the leading fuel transit firms in Estonia. His wife's identity as the third "mystery shareholder" in the company, along with its two public owners, Aadu Luukas and Endel Siff, was disclosed only in 1995 after the Commercial Register came into force. Kanajev later formed Transit Center (Transiidikeskus) with Luukas, Siff, and others, which was similarly involved in transit to the port. In addition to the deal with the Port of Tallinn, soft pricing from Estonian Railways was another crucial factor in the partners' success, as we will see below. In 2011, Kanajev launched a court battle against the Port of Tallinn's previous decision to grant concessions to Rail Garant, a Russian firm with mysterious ownership. He accused the company, without the slightest hint of irony, of having senior Port of Tallinn officials among its shareholders. He won this battle in 2012 and his container terminal, Muuga CT, was awarded the concession.¹³⁷

Oleg Ossinovsky likewise became one of Estonia's richest businessmen through soft subsidies from Estonian Railways. Spacecom, a subsidiary of Severstal which he jointly owns with the Russian steel giant, is Estonian Railways' biggest customer. Spacecom was believed by some to have had a role in an attempted raid on American-owned Baltic Rail Services (BRS), which privatized a majority stake in Estonian Railways in 2001.¹³⁸ In doing so it upset some very powerful customers of the railways company who relied on it to move their goods to Estonian ports. Among these were Spacecom as well as Pakterminal, which transports Russian oil using Estonia's rail infrastructure (though by that time, according to a source at BRS, Kanajev no longer had a deciding voice in Pakterminal and so did not play a part in this raid).¹³⁹

Estonian Railways has historically charged key customers like Ossinovsky's Spacecom absurdly low prices to transport their goods to the ports; in 2005 it cost \$27 to transport Russian crude as far as the Russian-Estonian border but a mere \$3.70 once it reached Estonia. The political parties who traditionally controlled Estonian Railways ensured the continued provision of these subsidies.¹⁴⁰

When BRS took ownership of the state firm, it raised access fees to normal levels. This served to concentrate the minds of the transport lobby. The subsequent attack on BRS was led by Edgar Savisaar, the father of Estonian independence and the head of the Center Party who became Minister of Economic Affairs and Communications in 2005. When Spacecom stopped paying its bills to Estonian Railways and was denied rail services as a result, Savisaar handed down a written order mandating that its access be

¹³⁷ Sulev Vedler and Tarmo Vahter, "Muugal miljard krooni maksnud kai koos maatükiga on läinud jumal-teab-kelle kätte," *Eesti Ekspress*, 6 November 2012 (<http://ekspress.delfi.ee/news/paevauudised/muugal-miljard-krooni-maksnud-kai-koos-maatukiga-on-lainud-jumal-teab-kelle-katte.d?id=58260480>); "Russians to sell Muuga container terminal project to Anatoli Kanajev," *Äripäev*, 12 April 2013 (<http://balticbusinessnews.com/article/2013/4/12/russians-to-sell-muuga-container-terminal-project-to-Anatoly-kanajev>); Interview with Sulev Vedler.

¹³⁸ Plutocratic Raid #2. The following information on BRS and Estonian Railways comes from an interview with an anonymous source at BRS, except where otherwise noted.

¹³⁹ Kairi Kurm, "Luukas sells Pakterminal stake," *Baltic Times*, 9 November 2005 (<http://www.baltictimes.com/news/articles/13981/>); interview with source.

¹⁴⁰ Ibid.

restored. Savisaar's ministry also hounded BRS for switching from using Russian locomotives to better-made American ones, citing the ridiculous rationale that the American cars are "too heavy" for Estonian tracks. "A lot was done to stop American locomotives running here," according to a source within BRS. "The Port of Tallinn was instructed by the Ministry not to load these locomotives because it would allegedly destroy the port equipment. This was complete bullshit."

The Ministry also directed the Railways Inspectorate and Competition Board, which regulates the rail transport system, to harass Estonian Railways in order to undermine BRS. "The railways agency received political orders to stop us by any possible means," the source complains. Its head, Oleg Epner, "was screwing us as much as possible," sending inspectors in just before weekly repairs were scheduled and citing the company for the tiniest deviations from regulatory standards (which are inevitable on any railway due to the infrastructure's complexity, according to my source).

Paradoxically, aspects of the raid on BRS illustrate the superior integrity of Estonia's state institutions as compared to those of the other three countries. Had an attack like this occurred in Poland, for instance, one would have likely observed collusion among multiple state bodies from the Tax Office to the Social Insurance Fund and the Supreme Audit Office, not to mention myriad prosecutors and judges. In the BRS raid, however, none of the equivalent Estonian agencies intervened on the raiders' behalf. Juhan Parts, whose premiership spanned part of this period, went all out in his campaign to engineer a criminal investigation of BRS for alleged corruption in the Estonian Railways privatization. To the credit of Estonia's investigators, he never succeeded.¹⁴¹ The Finance Ministry also treated Estonian Railways commendably despite political pressure to do otherwise; "if you made a good case to them, they would admit you were right and refuse to carry out the political orders," says the source. It likewise received fair treatment from the Health Protection Inspectorate.

BRS finally reached a deal with the government to buy back its stake in Estonian Railways. But it accomplished this only after invoking the Investment Treaty between Estonia and the United States to defend the company's interests. Until that point, reports my source, "there were lots of indications from Russian businessmen to the effect of 'I have paid it all [to the politicians]; you will lose'." Ironically, once the state regained control of Estonian Railways, the government jacked up its access fees to market levels, to the great consternation of the rail company's influential customers. "The government's idea," as the source describes it, "was, 'screw the private owner. But so long as we have control, we will make money'."

Crony Capitalists

In addition to the political thugs described thus far, a number of Estonian plutocrats can be considered crony capitalists, at least in the strict sense of how they first obtained a foothold in business.

One of these is Toomas Annus. His beginnings were clean enough, to be sure, having bought a construction company in a legitimate privatization. Renaming it Merko, he proceeded to build it up through state contracts, although there is little concrete evidence that any of these were obtained improperly. While the public procurement law

¹⁴¹ Interview with Enno Tammer, 5 November 2008.

mandates that contracts be awarded to the lowest bidder, the costs of construction contracts typically end up ballooning thereafter, resulting in final costs up to 30 percent above the initial price. But this is a problem inherent in the law and Merko has not been alone in benefiting from the loophole.¹⁴² Merko also controls Merko Kaevandused, a subsidiary involved in mining oil shale, a similarly politicized sector that depends on official licenses.

Around 2008, Annus and Merko became mired in various scandals involving the purchase of land from municipalities. In one deal, Merko got around rules limiting land purchases by companies to 10 hectares or less. It did so by loaning money to an employee to buy a 50-hectare tract. Shortly thereafter, the employee obtained municipal approval to divide the land into segments that individually complied with the ten-hectare requirement. He then sold them all to Merko. The transaction also appeared to stretch, if not violate, the rules governing the stated purpose of such lands. At the time of the tender, the land was sold as profit-yielding real estate, which can be purchased only by individuals, not companies. Afterward, Merko managed to secure fast-track approval from local authorities to re-designate the land for commercial use, thus allowing Merko to develop it. This was only one of several similar schemes that Merko carried out. In another case, the Viimsi municipality sold land to a private investor who in turn sold it to a Merko subsidiary. Shortly afterward, the municipality bought the land back from Merko at a healthy markup.¹⁴³

Urmas Sõõrumaa, another crony capitalist, has been involved in similar land deals to those just described. In 2001, an employee at one of his companies purchased 100 hectares of land from the Keila municipality. Three months later, he sold it to OÜ Rannailu, a firm jointly owned by Sõõrumaa's company, US Invest, and a Merko subsidiary. Helping along this process was the Center Party's Minister of Environment, Villu Reiljan (more on him below). It later emerged that OÜ Rannailu had granted an unsecured loan of EEK3 million to the Center Party. Sõõrumaa and Reiljan became embroiled in another scandal after details surfaced of a one-million kroon loan from Sõõrumaa's firm to the Minister.¹⁴⁴

Sõõrumaa began his career as the bodyguard of Soviet Estonia's last President. In the early 1990s, he established the Estonian Security Service (ESS), building it up into the biggest privately-owned security company in Estonia. This was a legitimate security firm, to be sure, not a protection racket masquerading as a legitimate firm as is so often the case in Ukraine, Poland, and Slovakia. It was rather Sõõrumaa's next big move that really turned heads. In 1998, a controlling stake in another state security company, EVK Group, came up for privatization. ESS was banned from participating since it already controlled too much market-share in the industry. But Sõõrumaa got around this restriction by setting up a second company in which he was not listed as the official owner. The privatization was eventually awarded to this company despite the fact that its links to Sõõrumaa were practically a matter of public knowledge. A year later, ESS

¹⁴² Interview with Peeter Raidla, 10 November 2008; Interview with Sulev Vedler, 18 September 2008.

¹⁴³ Ralf-Martin Soe, "Seadus sundis tankisti kasutama," *Äripäev*, 4 April 2008 (<http://www.Äripäev.ee/?PublicationId=7525794f-465b-42a5-a792-c553761b1ab4>).

¹⁴⁴ Ibid.

formally acquired the firm and rechristened itself 4GS, which now dominates Estonia's private security sector.¹⁴⁵

In addition to the EVK privatization, Sõõrumaa also won an auction for five schools in Tallinn. This allegedly came as a result of his relationship with Savisaar, the leader of the Center Party which governed the city at the time.¹⁴⁶

While none of the above deals were proven to be illegal, others involving Annus clearly did break the law. In 2013, he and several others were convicted of bribery in connection to the so-called "land-exchange" scandal. The case concerned the exploitation of a law designed to assist Estonian victims of Soviet land confiscations who were seeking restitution. In the event that the victim's property had since been designated environmentally-protected land by the state, the rightful owner could exchange the protected land for commercial real estate.¹⁴⁷

However, two groups of businesspeople, one of which assembled around Annus, saw an opportunity to game the system. They began buying up protected land and exchanging it for valuable commercial real estate in the center of Tallinn. What's more, they did not have to wait years for the process to drag out like everyone else did; by bribing officials from Estonian Land Board (which registers all land deals) in addition to Reiljan, the Environment Minister, the relevant administrative approvals sailed through. "They made a fortune," according to Toivo Tänavsuu, a journalist. "And the officials who authorized the exchanges were given 'hidden' shares in return." After Sulev Vedler broke the story, Reiljan was forced to resign. He was eventually convicted, as were scores of others including Annus, former Agriculture Minister Ester Tuiksoo, former Land Board head Kalev Kangur, former Tartu municipal official Tarmo Pedjasaar, and two businessmen, Einar Vettus and Tullio Liblik.¹⁴⁸

Margus Linnamäe, another crony capitalist, owns Magnum Group. Its key holding is Magnum Medical, which has become the largest wholesaler of pharmaceuticals in the country, controlling 44 percent of the market as of 2013. Clearly, the company has added some value to the Estonian economy; thanks to custom software it designed, practically all the major pharmacies in the country can place online orders and receive the goods in just three hours. It also made the Apotheka retail pharmacy chain more efficient by pressuring it to harmonize its structure and product mix. However, Magnum Medical and the Magnum Group have clearly benefited from soft budget constraints and other privileges over the years. Its market position remains so entrenched due in large part to legal limitations inhibiting new entrants into the pharmaceuticals industry. Linnamäe and Magnum are known as major donors to political parties; in 2008, it was the biggest source of financing for the Pro Patria Union.¹⁴⁹

¹⁴⁵ Rasmus Kagge, "Valvekoondise müümine ESSile oli ette teada," *Postimees*, 27 June 1998 (<http://archive.today/tmD8#selection-21.0-21.43>); Interview with Peeter Raidla, 10 November 2008; Interview with Mihkel Kärmas, 22 October 2008.

¹⁴⁶ This is according to Peeter Raidla, who recounted this to me in an interview on 10 November 2008.

¹⁴⁷ Interview with Sulev Vedler, 18 September 2008; "Estonian appeals court overturns land swap case acquittal," *Postimees*, 19 June 2013.

¹⁴⁸ Interview with Sulev Vedler, 18 September 2008; "Estonian appeals court overturns..."; communication with Toivo Tänavsuu, 11 August 2014.

¹⁴⁹ Sulev Vedler, "Vana Kuld: Kuidas Postimehe Uus Omanik Rikkaks Sai," *Eesti Ekspress*, 10 September 2013; Harry Tuul, "Eesti Esimene Magnaat: Margus Linnamäe," *Ärileht*, 9 September 2013.

Linnamäe founded Magnum in the early 1990s along with his brother, Aivar, and Georg Gavronski. Their start-up capital came from distributing medicines to pharmacies in Russia. Magnum went on to benefit from a number of questionable privatizations. In 1995, it privatized the Tartu Brewery for EUR26 million. It quickly turned around and sold about one-sixth of the shares to a foreign investor at a big mark-up. It then declared a loss on the sale and so ended up paying no income tax; the profits reportedly went offshore, thus preventing the tax authorities from collecting any money. Aside from the Tartu Brewery, Magnum also took part in the privatization of the Silmet Brewery. Its partner in the privatization was Florida millionaire Thomas Bjorn Waldin, a good friend of Prime Minister Tiit Vähi. Magnum caused a scandal when in 1998 and 1999 it sold its stake to Vähi himself. Furthermore, it turned out that Magnum had won the privatization on the basis of a fake bank guarantee; whether the Estonian Privatization Agency ignored this fact due to pressure from Vähi or its own oversight mistake remains unknown. Later, Magnum privatized the Estonian Pharmaceuticals Plant (Tallinna Farmaatsiatehas) but failed to make good on the long-term lease payments. The resulting scandal led to the prosecution of Jaak Liivik, the head of the privatization agency, for criminal negligence.¹⁵⁰

Alar Tamming's business career began in the late Soviet period in the field of video piracy, albeit of the principled kind, he explains ("I am fundamentally opposed to any kind of licenses," he later said). In 1991 he founded Tavid a foreign exchange broker. His early success typifies that of many crony capitalists; interest-free loans from an offshore "mystery investor" provided the capital but Tamming turned this soft budget constraint into a highly profitable and innovative operation. In particular, Tavid proved a success all over Scandinavia by making commission-free transactions for customers, thereby reducing the cost of exchanging currency. However, along the way he maintained excellent ties with politicians, becoming the largest sponsor of the Reform Party.¹⁵¹

The final crony capitalist on our list is Rein Kilk. He privatized the Port of Pärnu with the help of local politicians but also privatized or built a number of other companies that have not been dependent on political connections for their success.¹⁵²

Entrepreneurs

While some plutocrats can be considered political thugs and crony capitalists, most fall squarely into the category of entrepreneurs. Berman, Gnidin, and Kovalenko (of BLRT) have already been mentioned. Another entrepreneur is Viktor Levada, who established Levadia Metall and turned it into the largest metal trader in Estonia (although it went bankrupt in 2011).¹⁵³ Mati Polli, Peeter Mänd, and Kaido Jõelett similarly built up Sylvester, a timber and paper producer, from modest beginnings and did so without relying on political connections.¹⁵⁴ They later cashed out to a Finnish investor (they were

¹⁵⁰ Ibid.

¹⁵¹ Toivo Tänavsuu and Sulev Vedler, "Alar Tamming, Härra Kuld," *Eesti Ekspress*, 3 April 2008.

¹⁵² Correspondence with Respondent #123.

¹⁵³ Interview with Peeter Raidla, 10 November 2008; Interview with Sulev Vedler, 18 September 2008;

"Creditors claim millions from Viktor Levada," *Baltic Business News*, 13 April 2011

(<http://www.balticbusinessnews.com/?PublicationId=0b93c531-1a1b-4174-aa05-c4bd67a936cc>).

¹⁵⁴ Interview with Peeter Raidla.

accused of evading taxes on the sale but eventually won their suit against the state).¹⁵⁵ Sonny Aswani is an immigrant from Singapore who became an Estonian citizen in 1999. He made a fortune in paper products and textiles after privatizing a number of companies in the mid-1990s, some of which were bankrupt at the time he purchased them.¹⁵⁶

Peter Hunt, who had been involved in business in Sweden since the late 1970s, came to Estonia in the mid-1990s and began importing fabrics from Asia. He gradually privatized a carpet factory that would go on to serve as the foundation of Wendre, his multinational textile producer that sells to well-known chains such as Ikea, Carrefour, and Desko. He has no known political associations; he is a simple case of an entrepreneur who succeeded by producing in large quantities and selling at low prices.¹⁵⁷ Tiit Aava was a respected real estate developer and construction magnate who died in 2013 at the premature age of 50. In the 1990s he bought substantial tracts of real estate, mostly from the beneficiaries of the restitution process undertaken to compensate the victims of communist land confiscations. He went on to build high-quality, upscale homes on real estate that was rapidly appreciating in value. He was known for cultivating political contacts, but these were not obviously essential in his rise to wealth.¹⁵⁸

Joakim Johan Helenius grew up in Finland and held positions at Goldman Sachs and Merrill Lynch before coming to Estonia in the early 1990s to take advantage of new business opportunities. He founded Hansa Investments, an investment bank, in 1992, which has helped channel Scandinavian money into Estonian investments. I could not find any evidence that political connections played a role in his success. His firm was tainted, however, by its association with the aborted privatization of Estonian Railways (it served as adviser to "Tony Massona," the alias of the Italian-American criminal figure who initially was awarded the contract).¹⁵⁹

Vello Kunman reportedly made his first million running a vegetable farm while still a student. But the real ticket to his success came in the 1995 privatization of Silikaat, a brick factory. Kunman moved the brick production offsite and turned the premises into the country's largest shopping center. He also made successful investments in a stone quarry as well as farms. While he donates to political parties, political connections do not appear to have played a role in his success.¹⁶⁰

Another entrepreneur who made his own way in Estonian business is Igor Izraeljan, owner of Technomar & Adrem, a timber processor. Aside from a scandal surrounding the bankruptcy of EVEA Bank, in which Izraeljan owned shares, his name

¹⁵⁵ Janno Riispapp, "Kaido Jõelett Käivitas Hiigelprojekti," *Äripäev*, 15 August 2013; Interview with Peeter Raidla, 10 November 2008; Interview with Sulev Vedler, 18 September 2008.

¹⁵⁶ Toivo Tänavsuu, "Sonny Aswani tahab püsti panna hiiglasliku messikeskuse," *Ärileht*, 3 May 2006 (<http://arileht.delfi.ee/news/uudised/sonny-aswani-tahab-pusti-panna-hiiglasliku-messikeskuse.d?id=51050978>).

¹⁵⁷ Sirje Niitra, "Peter Hunt: edu toovad õige hind ja suur kogus," *Majandus24*, 3 July 2010 (<http://majandus24.postimees.ee/283528/peter-hunt-edu-toovad-õige-hind-ja-suur-kogus>).

¹⁵⁸ Toivo Tänavsuu, "Ettevõtja Tiit Aava suri pärast Tartu maratoniraja läbimist," *Eesti Ekspress*, 21 February 2013 (<http://ekspress.delfi.ee/news/paevauudised/ettevotja-tiit-aava-suri-parast-tartu-maratoniraja-labimist.d?id=65715030>). Correspondence with Peeter Raidla, 9 July 2014.

¹⁵⁹ Andres Reimer, "Joakim Helenius Külvab Miljonäride Raha Ida-Euroopasse," *Postimees*, 7 May 2005.

¹⁶⁰ Mihkel Kärmas, "Lihtne Mees Võttis 122 Miljonit Krooni," *Eesti Ekspress*, 26 June 2008.

has never been associated with questionable dealings (he was never accused of anything in the EVEA case either by the authorities or the media).¹⁶¹

One entrepreneur we have already noted is Väino Kaldoja. Before founding Silberauto, he managed an auto park in the late Soviet period that provided cars for government bigwigs. When he was first starting out, his connections in Soviet Estonia's Council of Ministers allowed him to make use of its auto repair center. Aside from that, however, he is known to be an honest businessman. The benefits afforded by the soft budget constraint in the case of the auto repair center was likely of minor importance as a contributor to his overall fortune. I am therefore labeling Kaldoja as an entrepreneur.¹⁶²

Armin Karu and Jaan Korpusov are known for donating generously to political parties.¹⁶³ They have also had associations with possibly criminal partners in real estate deals. However, their origins are relatively pristine, having constructed Olympic Entertainment Group, their casino empire, from the ground up in the 1990s.¹⁶⁴

Margus Reinsalu started his career in the early 1990s as the CEO of Tallinn Taxopark, which he then privatized with his business partner Mati Saar. He used some of the real estate owned by Tallinn Taxopark to build the Kristiine Shopping Center. He then founded Kristiine Casino in 1996, which he later sold to Karu and Korpusov's Olympic Entertainment Group, its main competitor (see above). Since then he has focused on international real estate development.¹⁶⁵ (However, a major project in Morocco has gone sour and descended into mutual recriminations among Reinsalu and his partners as well as suspicions from clients that their money simply disappeared.)¹⁶⁶ Hillar Teder is also an entrepreneur. Having started his business career in the late-Soviet era, he eventually turned it into a major hypermarket chain operating in Russia and other countries around the region.¹⁶⁷

Hans Luik, another plutocrat, built Ekspress Group, his media empire, without any known associations with the state. His career has not been free of scandal, however. In 2008, articles appeared describing loan-sharking operations on the part of a number of businesspeople, including Luik.¹⁶⁸ Operating in a largely unregulated market, Luik simultaneously owned one firm that issued loans and another that collected on them once they went into default. His debt-issuer, Krediidikassa, lent money at high interest rates to

¹⁶¹ Peeter Raidla, "740 miljoni mees," *Äripäev*, 10 February 2004 (<http://arileht.delfi.ee/archive/740-miljoni-mees.d?id=7201508>); Interview with Peeter Raidla, 10 November 2008.

¹⁶² Interview with Peeter Raidla, 17 November 2008; Interview with Sulev Vedler, 18 September 2008; Toomas Hõbemägi, "Car dealerships – the pride of Estonian capitalists." *Baltic Business News.com*, May 6, 2002.

¹⁶³ Interview with Tarmo Vahter, 8 October 2008.

¹⁶⁴ "Real estate businessman owns two houses claimed to be brothels," *Baltic Business News*, 26 February 2008 (http://www.balticbusinessnews.com/article/2008/02/26/Real_estate_businessman_owns_two_houses_claimed_to_be_brothels); Interview with Sulev Vedler, 18 September 2008.

¹⁶⁵ "Margus Reinsalu – kasiinomeistri kinnisvarakuningaks," *Mees.eu*, 19 October 2008 (<http://www.mees.eu/artikkel/margus-reinsalu-kasiinomeistri-kinnisvarakuningaks.html>).

Correspondence with Peeter Raidla, 9 July 2014.

¹⁶⁶ Toivo Tänavsuu, "Kinnisvaraäri eesti moodi: 60 miljonit eurot rikaste eurooplaste sääste kadunud," *Eesti Ekspress*, 4 April 2013 (<http://ekspress.delfi.ee/news/paevaudised/kinnisvaraari-estee-moodi-60-miljonit-eurot-rikaste-eurooplaste-saaste-kadunud.d?id=65918584#>).

¹⁶⁷ Interview with Sulev Vedler, 18 September 2008.

¹⁶⁸ Interview with Peeter Raidla, 10 November 2008.

consumers. The debt-collector, Julianus Inkasso, aggressively sought to recover the loans through threats of bankruptcy, arrest, and prison time - even for debts whose statutes of limitations had already expired.¹⁶⁹

Finally, Heldur Meerits, was a co-founder of Hansapank, which he built up into a successful financial services provider and ultimately sold it to Swedbank. My sources universally hail him as a successful entrepreneur who made his fortune from building true economic value.¹⁷⁰ However, he did serve as deputy governor of the Bank of Estonia at the same time that the central bank privatized 20 percent of the Estonian Savings Bank (Hoiupank) to Hansapank, where Meerits was still shareholder. The privatization took place during the first Laar government (1992-94). The question of whether he exerted any influence over the sale was never adequately answered, and initial ruminations in parliament soon fizzled out.¹⁷¹ For this reason, it remains uncertain whether Meerits should be classified as an entrepreneur or crony capitalist.

Most of Estonia's plutocrats can thus be considered entrepreneurs. This is in stark contrast to those of Poland, Slovakia, and Ukraine.

State from Scratch: The Construction of an Estonian Bureaucracy

At the time of Estonia's independence in 1991, a betting man or woman would probably not have wagered that it would become one of the post-communist leaders, if not *the* leader, in constructing effective property-rights institutions. To begin with, it faced the same problems seen everywhere else in the region. Private economic activity had already begun in earnest yet the country did not have the necessary institutions to regulate it. Informal markets and criminal activity were flourishing. The economy was in tatters; mass disruptions and shortages of supplies were the order of the day. Salaries of state personnel were low while professional civil servants versed in Western-style governance and jurisprudence could scarcely be found.

To make matters worse, Estonia's size - it was smaller than every other post-communist country - carried unique disadvantages. Anatol Lieven articulately summarized the special problems confronted by Estonia along with Latvia and Lithuania, its two Baltic neighbors:

In comparison with the countries of Eastern Europe, the Baltic States, as constituent parts of the Soviet Union, were at a colossal disadvantage as they set out to free themselves from Communism and reform their states and economies. Whereas the East European satellites possessed at least the formal attributes of independent statehood, however theoretical they may have been, the Baltic states lacked their own currencies, armed forces, border guards, diplomatic services, central or even local banks, railways, airlines, and even tourist offices... The Baltic economies were wholly integrated into that of the Soviet Union, and overwhelmingly controlled from Moscow: the great proportion of local revenue,

¹⁶⁹ Toomas Hõbemägi, "Debt collection agency claims outdated debt for Elisa," *Baltic Business News*, 27 March 2008; Sandra Taimre, "Debt collection agencies connected to loan companies," *Baltic Business News*, 4 July 2008.

¹⁷⁰ Interview with Mihkel Kärmas; Interview with Enno Tammer; Interview with Peeter Raidla.

¹⁷¹ Interview with Peeter Raidla.

including virtually all the hard currency, vanished to Moscow. Even with goodwill on the Soviet side, the task of separating Baltic institutions from centralised Soviet ones would have been a hideously complicated process. Where the Baltic Soviet republics did have their own institutions, these were very often mere departments of ‘All-Union’ ministries in Moscow, staffed from the centre... Each institution had therefore to be constructed largely from scratch, rapidly, and in conditions of political insecurity... The Balts had also to effect reforms and build institutions amidst an economic decline without parallel in the peacetime history of Europe. Even the Great Depression of the 1930s did not see industrial production decline by more than 30 percent over two successive years, real wages fall by some 45 percent, or fuel prices rise by more than 10,000 percent over the same period, while inflation climbed for a time to more than 1,000 percent per annum and real unemployment soared.¹⁷²

If Estonia did not have much of anything in the way of a basis for market-supporting institutions, it was fortunate to have a group of remarkable and highly-motivated actors dedicated to building them.¹⁷³ It all began with the September 1987 publication of a pivotal newspaper editorial, “The Whole of Estonia Toward Self-Government” (*Kogu Eesti Täielikule Isemajandamisele*). The authors - Siim Kallas, Tiit Made, Edgar Savisaar, and Mikk Titma - would all become major players in the reform process, which took on the abbreviation IME (for *Isemjandav Eesti*, or Self-Governing Estonia). The article touched off a wide-ranging debate in Estonian society over the proper nature of the reforms.

However, if the particular character of the reforms proved contentious, the reform imperative itself was not. Recognizing the upsurge of popular support for change, the Estonian government began appointing reform-minded leaders to important official posts. “The people at almost every level of government were almost completely replaced at the beginning of the 1990s,” Kokk recalls. “And this, as far as I know, is actually one of the unique features of Estonia in the old Soviet bloc... By ’89 we had a kind of parallel government in place. It had no power, but all the documentation was ready.”

Four people, in particular, played key roles in the creation of Estonia’s new state institutions: Savisaar, Jüri Raidla, Jaak Leimann, and Raivo Vare. Just before the 1989 elections to the republican Supreme Soviet, the government created a new State Chancellery to oversee the process of establishing a basis for self-government. Under Leimann’s stewardship, the State Chancellery became, in Vare’s words, an “incubator” for a broad range of brand new state institutions and the reorganization of existing ones. The pool of recruits for the new bodies came mostly from that part of society engaged in the debates over the IME. “So all the key people were already known because they were already involved,” Vare recounts. But it was extremely difficult to find qualified personnel; many were scared to participate in the politically-charged process of carving important state functions away from Moscow’s control. The Soviet Union was still in existence and few people at the time had any inkling that it was about to disappear. “You can dispute with Moscow on legal matters,” Vare explains, “but it was extremely

¹⁷² Lieven, 316.

¹⁷³ Much of the following discussion draws on interviews and email exchanges with Aavo Kokk (14 October and 26 November 2008) and Raivo Vare (18 November 2008), except where otherwise noted.

dangerous when you started disputing on political matters. And that was exactly why many of them refused to participate... Basically, people were very, very afraid” of facing retribution from the Soviet authorities. “So it was very difficult to persuade them to come over and take positions.”

From 1989 onward, a massive reorganization of the state and its personnel began to unfold. Scores of long-serving officials were dismissed under the guise of a “reorganization” while a process of hiring new ones was swiftly instituted. “So it was a kind of parallel process,” Vare recalls - “the creation of new organizational positions, installing new people into these new positions, laying off some people and bringing in new people.” Some ministries were more affected than others. The Ministry of Industry, in particular, put up staunch opposition to economic and institutional reforms. Yet the reformers were not in a position to sideline its conservative leadership, who boasted broad support from large enterprise managers. But at the Ministry of Economic Affairs, almost all personnel were replaced. The old ministries, which initially numbered 42, were reduced to 28 and ultimately 15 after independence (including the ministries that had been entirely created anew). Because of the need to establish wholly new state institutions without antagonizing Moscow, most of the new functions remained inside the State Chancellery.

In terms of creating new state bodies, a few policy realms stood out in importance. One was a new Ministry of Economic Affairs. Another was a Ministry of Transportation and Communication; “this ministry was created from scratch,” Vare explains, “because during Soviet times, all of the transportation and communication systems were directly subordinated to Moscow... So this system was taken over in less than two years.” The old Soviet ministry fought the new one tooth-and-nail until the aborted coup of August 1991, after which its leaders departed for Moscow. Until that point, there were two separate ministries in charge of transportation and communication operating in parallel to one another.

Initially, however, the new ministry’s remit did not extend very far outside the building that housed it; few if any state enterprises recognized its authority, which had to be built up from nothing. According to Vare, the credit for this feat goes mostly to Tiit Vähi, its first minister (and later three-time Prime Minister). Vare recalls about Vähi that:

“He was a crazy guy in those days. And he had a very strong personality. Once, he was sent over to take control of northeast Estonia [where Russian-speakers are in a majority and pro-Union sympathizers were heavily concentrated] and he basically executed Estonian power there very mercilessly. That’s my point. He just took it over. He started to systematically press them and fight against each and every one of these local kings. They were kings of their own transportation kingdoms... and it was no easy task. It didn’t just happen in a single moment; it took a lot of effort and was very, very tricky. But I have to acknowledge his particular personality as a contribution to the success of this effort... I wouldn’t imagine that our present politicians have it in them.

Savisaar was a similar force by virtue of his strong personality. He assumed control of the Ministry of Economics in 1990, having previously been in charge of the State Planning Commission. During that year he also became Chairman of the Council of Ministers following the election victory of the Popular Front of Estonia. “Basically, he

had already taken over this ministry during the previous government [of Indrek Toome, 1988-90]. He began consolidating his power and started laying off people and installing his own people. He continued to keep a close eye on this ministry even once he assumed the prime minister's office."

At the Ministry of Economic Affairs, two Deputy Ministers were appointed along with three department heads. The first department head was tasked with ensuring the continued supply of goods from Moscow. A second was put in charge of dealing with internal shortages, which were reaching crisis proportions. The third was responsible for managing the day-to-day administration of the Ministry. While the State Planning Committee was brainstorming how much steel should be produced, "Savisaar started to use local think tanks to deliberately create a sort of theoretical framework for the future state." Aavo Kokk recalls. "He was defining the issues that the think tanks would discuss. So it was very organized...Savisaar was coordinating all of this. And so certain people would become interested in, say, taxes. They would get together and discuss taxation, and sooner or later most of them moved to the respective institution to work in this area. So this is where the new personnel came from. Most of my staff in [the Department of Taxation] had been a part of these discussions. They were interested in taxation, and they were later employed by the Ministry of Finance. And so it went."

"In this kind of embryo structure, we had to handpick people one by one," Vare explains; "it wasn't like we were reorganizing something that already existed, giving it additional functions, and then installing the right people...We thought out what we had to do, we thought out what kind of structure might achieve it, and we started recruiting people. So the structure was being created in parallel with the new people being hired...The same logic operated in other ministries, except the Ministry of Industry, where the minister under the new government heavily defended the present people and present structure."

Aside from economic affairs, transportation, and communication, another high-priority area from very early on was finance. Previously, all tax collection had been under central control from Moscow and tax revenues went straight there. The Estonian republic did not even have its own budget. But its early reformers began to change that, establishing an independent budget and tax-collection system by 1990, well before independence. "All that Laar had to do was to provide that last push to make it all come together," says Kokk. The proto-finance ministry was indeed central to the creation of a market economy. To finance the republican government independently of Moscow, an income tax and VAT were introduced. "The laws were naïve at first, yes. But they served their purpose...For the first time, Estonia had its own budget. Before that it was just split among the ministries." Meanwhile, Kokk continues, "Estonia had its own banking system from 1988, when the first private banks were created. Then, once you had a budget system in place, you had banks to transfer the tax revenues to the budget. So all of these old institutions representing Moscow simply had no financing anymore."

As the economy became more market-oriented, the Soviet institutions that previously managed the republic's economic affairs were increasingly rendered obsolete. "This was the way the old Soviet system lost its steam; nobody needed [its officials and administrators] anymore...There was no need for them. You're sitting there in your office and nobody's coming. This was the way these old state workers were just wiped out," says Kokk.

It was the ultimate inversion of Marx's famous prediction; instead of the capitalist state withering away, it was the communist party-state that withered in order to make way for the new capitalist system.

"There was a particular logic to how these new institutions established their authority," Vare explains. "It began with the creation of new functions, and then these new functions entailed new responsibilities and new rights... [The new institutions] became the center of power even while the old system formally continued to exist. But the new people gradually became the focal points because everybody began to understand that it is wise to deal with them, because, in practice, they are the ones in charge."

The twin processes of building new state institutions and sidelining old ones began long before Laar and the Pro Patria party took office in October 1992. It was the communist leadership who initiated these developments in 1989. After independence, the various proto-ministries emerged from the protective confines of the State Chancellery and assumed the form of official state agencies. "All these organizational reforms made during the transition era were scaled back and these departments - like the economics department, the defense department, etc. - were taken away from the State Chancellery and transformed into their respective ministries," Vare recalls. "It all happened in three-and-a-half years, basically from the second half of 1989, when the reforms started under the [Toome] government [1988-90], the entirety of the [Savisaar] government [1990-92], the entire Vähi government [January-September 1992] and to the end of 1992, when the Laar government came to power and the new Law on Government was actually adopted."

As State Minister, Vare had ultimate authority over the appointment of personnel. As much as possible, new civil servants were recruited on the basis of merit and motivation, not political considerations. "It was all about brightness and nothing to do with party affiliation. Especially in small societies like ours, that doesn't work. It just doesn't work. You just can't afford to appoint people on political grounds. You do not have the luxury of wasting your limited resources," he insists. "There was no need for head-hunting because you already knew a lot of those who were involved in drafting the IME program... Some were even involved in fighting against it. I recruited several people who had actually fought against us, but it didn't matter because they were bright."

Communists and former communists were not excluded from consideration, although those regarded as corrupt or especially compromised by involvement in state repression were shunned. "The communist party still appointed bright people sometimes. It's not like they all were fools," Vare explains. "They appointed bright people, though usually not to key positions. They were in lower-level positions. So you just promote them. The main criteria was that they should not be fools and that they should be committed. Basically my interviews with these people were about why they should come over and what their motivations were - nothing else. Because what else could I promise? Basically nothing, because the pay was low and the risks were high." Kokk, who worked at the new Finance Ministry, agrees; "perhaps there were even people from the communist party there. But this was not the major issue. The issue was, 'are you interested in doing something, and do you know what you are doing?' So professionalism and knowledge were the basic elements; no 'empty suits' were tolerated."

Given the novelty of the policy spheres they had to regulate, strong motivation was about all that many of the new personnel brought with them. Kokk was 27 years old when he arrived at the Finance Ministry, and he was among the older officials who served there. “In ’92, I was head of the Taxation Department in the Ministry of Finance. I had no tax background before that, and none of the people in my department studied taxation at university... Now 90 percent of the people staffed in this department have a legal background. But we just had to build it up somehow.”

In the absence of established rules, agents and their decisions became critical to forging new institutions and norms of official conduct. This was all the more apparent on the local level, where it was mostly up to local officials to determine how easy or difficult it would be to operate a business. “Do you encourage restaurants and small shops, or not? It does not depend so much on some legal framework,” Kokk recounts. “If, say, an official is lazy and is not giving approval on sanitation norms and the mayor comes over and asks why it is so slow, that makes a difference.”

Certain institutions were slow to change, particularly the police, the prosecutors’ offices, and the courts. In these spheres, one did not see the same process whereby new institutions and agencies were created from nothing and operated in parallel with existing Soviet-era ones. Instead, independent Estonia would inherit its policing and judicial institutions from the Soviet system. “The institutions that had no alternative earlier were established earlier, and the culture there was much more of a Western-oriented one. The institutions that stayed as they were, those institutions were much slower to change,” says Kokk.

Even in these cases, however, there occurred an intensive process of institution-building. After all, the market economy gave rise to entirely new areas of law that had first to be established and then enforced. The Soviet judicial system was completely ill-prepared for the new market. The criminal justice system was geared toward punishing assault, murder, and the theft of state property. Criminal prosecution in areas such as tax evasion and regulatory violations had to be developed entirely *de novo*.¹⁷⁴

In the civil courts, too, it took years to develop institutions that could effectively preside over the new system of market exchange. In communist times, civil justice was focused exclusively on housing, family law, payment of damages, and work-related disputes. There was hardly anyone with experience in the complicated corporate litigation, copyright law, contract and bankruptcy law, ownership disputes, and real estate law that are hallmarks of a market economy. Now, of course, all of these legal specializations are part of the standard law-school curriculum. At the time, however, prosecutors and judges were forced to learn on the job. Judges underwent a two-year retraining program. Because Estonian law borrowed so heavily from German law, German legal experts were brought over to assist in the training of judges.¹⁷⁵

Not only was there a shortage of qualified personnel, the laws on the books were woefully inadequate. Until the 2002 passage of Law on Obligations (which governs contract and tort law), there were major gaps in civil law while many areas were hardly regulated at all. All that existed up to that point was the 1964 Civil Code which, needless to say, offered little guidance in such areas as bankruptcy and corporate litigation. Moreover, caseloads remained heavy until a 2006 law streamlined procedures for settling

¹⁷⁴ Interview with Helve Särgava, 6 November 2008.

¹⁷⁵ Ibid.

minor claims. Even as of 2008, the system was considered slow by the standards of Germany's courts.¹⁷⁶

A far more pressing problem throughout the 1990s was the low pay and heavy workloads Estonia's judges had to endure. A shortage of judges led to long delays in judicial proceedings; people who were arrested were not having their cases reviewed.¹⁷⁷ The situation would eventually improve dramatically but only in the late 1990s. A vetting process was instituted to weed out judges who were politically compromised or lacked sufficient Estonian language skills. But this created scores of vacancies that had to be filled, particularly in Tallinn and Ida-Viru County (both regions with heavy Russophone populations).¹⁷⁸

Meager pay exacerbated the shortages. "It was very hard to find judges because the salaries were extremely low," recalls Helve Särgava, who began her long career as a judge during Soviet times. This state of affairs is naturally conducive to corruption, but in Estonia none of the judges or prosecutors I spoke to recalled any cases of bribery or influence-peddling in the judicial system at the time. "During this difficult period there were no such instances of corruption," Särgava says. Later on there would arise a handful of cases implicating judges in taking bribes, but these did not occur until after 2000. Furthermore, the judges involved only assumed their posts in the late-1990s, not the early post-independence era. "The first vetting process ensured that all of these judges were extremely loyal. But because there were now so many vacancies [by the late-1990s], they could not be as discerning in who they hired. So later, perhaps, some less loyal people were selected."¹⁷⁹

In the investigating agencies, it took years before there developed an effective capacity to police corruption. The Security Police was established in 1991 but, according to its current director, Arnold Sinisalu, "corruption only became a big priority around 1996. Before that point, there was no anti-corruption law. So only the anti-corruption sections of the penal code could be used." Furthermore, at the time the agency began its work, the youthful agents it hired lacked the requisite experience to investigate complex corruption cases; that was something which would take time to develop. Nevertheless, officers in the Security Police did not have to suffer the low pay forced upon employees of other agencies. "The politicians knew what they had to do. They paid a lot of attention to making sure we were well-paid," Sinisalu recounts.¹⁸⁰

An interim criminal code was adopted in 1992, stripped of any obsolete and repressive elements from the old Soviet code. But the pay remained low, resulting in mass departures and severe staff shortages; "everyone else received better salaries than we did," recalls Alar Kirs, who worked as a prosecutor during the early 1990s. "Also, the system needed foreign-trained lawyers, and there only a minimal amount of them." Estonia did receive considerable assistance from foreign law enforcement agencies, which organized extensive study tours and on-site trainings; the Prosecutor's Office, in particular, was assisted by advisers from Germany, Finland, the Netherlands, the United

¹⁷⁶ Ibid.; Interview with Merike Varusk, 24 September 2008.

¹⁷⁷ Interview with Respondent #107.

¹⁷⁸ Interview with Helve Särgava, 6 November 2008.

¹⁷⁹ Ibid.

¹⁸⁰ Interview with Arnold Sinisalu, 7 November 2008.

States, and other places. But the quality of facilities and transportation was a constant problem. “There was a lack of everything.”¹⁸¹

The upshot of this all was that, until the late 1990s, the institutional infrastructure of the new Estonian economy was new, malleable, and constantly in flux. Temporary rules and official bodies were the order of the day. “There were lots of temporary functions,” Vare remembers. “It was very common to create temporary commissions headed, for example, by a state minister. For instance, there was a need to create a so-called economic border, which was actually the embryo of the current state border. It was heavily opposed by the Soviet regime for obvious reasons. Because of this, an extraordinary governmental commission with special authority was created which existed outside the rules. We basically confiscated property from the state - mainly state-run companies - and gave it over to the new border guard system. We did things which are unimaginable nowadays.” Vare continues:

In those days, because of the transition, government was very much exercised by temporary rules - the so-called Temporary Statutory Documents of the ministries - which were accepted not by the parliament but by the government itself. The parliament was constantly beset by typical political infighting even in those days. But the transition required quick moves and that was exactly how we proceeded: we made new moves, creating new statutory documents for new ministries, reorganizing them, recruiting new people and then installing them. Then real change would start to happen and people began to think about how to get rid of the old ministries.

Thus, Estonia’s new leaders were hardly relying on parliamentary legislation at all, instead making up temporary rules as they went along. It was from these shifting sands that the country’s new institutions arose. The reform-minded leadership of the new Ministry of Economic Affairs, for example, found embroiled in conflict with the relatively conservative officials around the old Ministry of Industry. This, Vare explains, prompted a good deal of institutional improvisation. “These two [ministries] were at extremely sharp odds with each other, and we [the Ministry of Economics] had problems with them all the time. As a consequence, we created a separate structure - again, typical. If you have no other options, create a new structure. We created this structure within the State Chancellery, which was called something like the Department of National Economics. The function of this department was to put together the two ministries of economics and industry.”

A similar degree of flux characterized local governments, which were initially granted broad powers; the widespread fear of a conservative Soviet backlash convinced the republic’s new leadership to decentralize power as much as possible. After independence, these powers were scaled back and re-concentrated in the hands of the central government.

“We used to joke that the law changed every Tuesday and Friday,” recalls Peeter Lepik, conveying just how unstable the rules governing business were at the time.¹⁸² “Tallinn is today often referred to by its inhabitants as ‘the Wild East,’” wrote Anatol

¹⁸¹ Interview with Alar Kirs, 9 October 2008.

¹⁸² Interview with Peeter Lepik, 3 November 2008.

Lieven in 1993. “The new Baltic police have...inspired little confidence, being generally extremely young, often violent and sometimes wholly ill-trained. Meanwhile the old force, demoralized by poor pay, by the collapse of the Soviet Union, by the mistrust shown by the new governments, and by ethnic prejudice and by insecurity over their future, has virtually collapsed.”¹⁸³ “It was cowboy capitalism,” says Lepik.¹⁸⁴

Even the much-vaunted Section Six in the Ministry of Interior found it difficult to focus on combating organized crime; staffed mostly by Russian-language speakers with little enthusiasm for an independent Estonia, it was in perpetual conflict with the post-independence government. “These Section Six people were involved in such a bitter struggle that they didn’t have time for other things,” Vare remembers. “And they were in a difficult position, I have to say. Therefore, a lot of functions which are normally performed by the Ministry of Interior were in those days completely out of its hands.” During the first nine months of 1992, the Vāhi government dismissed a quarter of the border guard. It also confronted the trying task of subordinating the large state enterprises under Estonian control, most of which had previously been regulated by Moscow. This was made all the more difficult, Lieven explains, by the fact that, “[d]uring the period 1989 to 1992, managements were balanced between the Baltic governments and Moscow, obeying neither, an ideal opportunity for ‘spontaneous privatization’.”¹⁸⁵

According to a longtime prosecutor, it was very easy to get away with economic crimes in the first half of the 1990s. This was so for the simple reason that there hardly existed any laws designating them crimes in the first place. “It only makes sense to bribe when you know you have broken the law. At that time there was no need to offer the bribe because there was often no law.”¹⁸⁶ A formal civil service code establishing an independent and apolitical civil service was not adopted until 1995,¹⁸⁷ while the Public Service Act, mandating merit-based recruitment in the civil service, came only in 1996.¹⁸⁸ Until then, all that the civil service had to go on was the integrity – or lack thereof - of its political masters.

Fortunately for Estonia, these masters had already established a precedent of recruiting civil servants on merit well before independence, as we have already seen. But once again, this was a case of actors taking the initiative to create new rules and norms where few existed before. At the same time, the degree of bureaucratic professionalism in this period should not be overstated; “it has become obvious by the year 2000,” wrote one commentator in 2001, “that the development of public administration is far behind the economic reforms initiated, and it acts as a brake on continuing reforms, further stabilization and joining the European Union.” That author specifically cited the persistently low level of professionalism in the bureaucracy.¹⁸⁹

¹⁸³ Lieven, 317.

¹⁸⁴ Interview with Peeter Lepik, 3 November 2008.

¹⁸⁵ Lieven, 332-33.

¹⁸⁶ Interview with Respondent #107.

¹⁸⁷ Grzymała-Busse, 100.

¹⁸⁸ Aare Kasemets, “The Long Transition to Good Governance: The Case of Estonia Looking at the Changes in the Governance Regime and Anti-Corruption Policy,” in *European Research Centre for Anti-Corruption and State-Building (ERCAS) Working Paper no. 32* (2012), 37.

¹⁸⁹ Randma, “A Small Civil Service in Transition: The Case of Estonia.” Quotation appears on p. 42.

Sinialu, of the Security Police, maintains that, because of low pay, corruption among civil servants was indeed a danger during the early 1990s. “At the beginning of the post-independence period, the bribe was so big and the salary so small that the officials had nothing to lose by taking it. Also, the prison terms were very light.”¹⁹⁰ And the specialized law-enforcement organs necessary to deal effectively with such complex crimes did not yet exist. The creation of an independent State Audit Office had to wait until 1995. The Financial Supervision Authority, although established as early as 1993, did not become free from the political control of the Finance Ministry until 1997.¹⁹¹ A Commercial Code requiring adherence to Western accounting standards was not adopted until 1995.¹⁹²

Compare this state of affairs to Poland, where key state institutions of monitoring and oversight already had a longstanding existence. The Supreme Audit Chamber (NIK) was established in 1977, the Ombudsman in 1987, and the Supreme Administrative Court (where citizens to complain about official law-violations) in 1980. To be sure, they would only acquire real enforcement powers once communism fell.¹⁹³ But at least they existed. In Estonia they had to be created entirely anew.

The consensus among the civil servants and other legal professionals with whom I spoke is that the enforcement capacity of Estonia’s state institutions really began to improve around 1998 and 1999. By that time, salaries had increased dramatically. In the courts, a provision was adopted granting judges life tenure with a retirement program. This drew many younger candidates to the profession and “the situation became much better,” according to Särğava.¹⁹⁴

The integrity of Estonia’s tax institutions has significantly improved since Aivar Sõerd used the Tax Board to attack rivals of Ühispank in the early 2000s. The same is true of the Financial Supervision Authority, which supervises financial institutions. According to Toivo Tänavsuu, the perception that the tax authorities are not to be messed with has become firmly entrenched in the popular mind. Free of scandal for well over a decade, the Tax and Customs Board projects the image of an innovative state agency, maximizing its reliance on automated servicing (such as e-declarations of taxable income) and minimizing the role of human beings in the process. “It’s possible to file your tax declaration in five minutes,” Tänavsuu adds. “I do it every month for my business.” The agency also has a reputation for efficiency and fairness in auditing businesses; it utilizes an entirely rule-based system for choosing which businesses will be investigated. Ever since the Sõerd scandal, the Tax and Customs Board has been headed by a career professional rather than a political appointee. Enriko Aav, who led the agency from 2006 to 2011, was especially well-regarded by the business community.¹⁹⁵ Wayward officials like Ahti Lille, who was convicted in 2005 for attempting to extort EEK 300,000 from a business, meet a justice that is swift and harsh.¹⁹⁶ Two prosecutors, Kadri Väling and Kristel Siitam-Nyiri, confirm that they have never heard of state

¹⁹⁰ Interview with Arnold Sinialu, 7 November 2008.

¹⁹¹ Grzymała-Busse, 100.

¹⁹² Nørgaard and Johannsen, 137-43.

¹⁹³ Grzymała-Busse, 103.

¹⁹⁴ Interview with Helve Särğava, 6 November 2008.

¹⁹⁵ Interview with Toivo Tänavsuu, 30 October 2008; Interview with Peeter Lepik, 3 November 2008.

¹⁹⁶ “Kohus saatis altkäemaksu nõudnud maksuametniku vangi,” *Eesti Päevaleht*, 3 October 2005 (<http://epl.delfi.ee/news/eesti/kohus-saatis-alkaemaksu-noudnud-maksuametniku-vangi.d?id=51020649>).

institutions – including but not limited to the Tax & Customs Board – being abused against businesspeople.¹⁹⁷

Further illustrating how much the tax system has evolved, Anton Sigal recounts a lecture he attended as a law student. The presenter went through all of the conditions that must be met in order for a tax official to levy a back-tax claim on a company. Unless each of those conditions are satisfied, the claim cannot be imposed. The speaker then contrasted existing rules with the far-inferior framework of the mid-1990s, showing as an example a 1994 order to impose back-taxes on a business. The order consisted of a single piece of paper in which the tax official had simply declared that the firm in question owed a tax of a certain amount. It was signed, simply, “Director.” Things can no longer be done this way, even if they once could.¹⁹⁸

But even in the 1990s, few of my sources remember many abuses by tax officials. The reason for this cannot possibly rest in the strength of the country’s tax institutions, which, as the anecdote suggests, were rather weak at the time. Indeed, the distinguishing feature of the new Estonian market was a relative absence of the systematic property rights abuses seen in so many other post-communist countries. How was this possible?

As the preceding discussion has shown, the feebleness of state institutions, at least until the second half of the 1990s, would have granted economic actors much leeway to engage in criminal activity. It would therefore be the nature of the actors themselves rather than the integrity of Estonia’s largely non-existent rules that would determine just how much these opportunities for exploitation would be seized. Given the fluidity of the situation and the vulnerability of its institutions to corruption, it became all the more important to marginalize the political thugs and crony capitalists who could potentially sabotage them. The new state institutions may have been staffed by young idealists, but if the post-communist experience proves anything, it is that young idealists can become easily corrupted. The key is to ensure that the economic predators with a vital interest in corrupting them remain on the sidelines. This Estonia did, and the way it did so was to rapidly subject emerging business actors to hard budget constraints.

Might the very need to create the institutions from scratch, as opposed to inheriting the corrupt institutions of the past, have enabled a new system of property rights to develop more rapidly? One cannot rule this out. Nevertheless, however easily new rules could be adopted, they would still take years to become sufficiently functional in protecting property rights. Yet *from the very start*, Estonia mostly lacked the kinds of abuses that marked the other three countries. This fact cannot be explained away by institutional factors for the simple reason that such factors did not yet exist.

The Outcome: Robust Property Rights Institutions

Even if Estonia’s institutions began their lives as weak and unstable, over time they have become remarkably efficient and authoritative. One indication of this, of course, is the relative absence of the kinds of property rights abuses experienced by the other three countries. By itself, however, this measure is insufficient; in general, the absence of observed abuses may or may not reflect the presence of sound institutions.

¹⁹⁷ Interview with respondents, 15 September 2008.

¹⁹⁸ Interview with Anton Sigal, 6 October 2008.

When criminal corporate raiding is widespread, as it is in Poland, Slovakia, and Ukraine, this fact alone provides adequate proof that property rights institutions are weak. If, however, we seek to demonstrate that Estonia's institutions have become strong, we must rely on additional indicators besides the low frequency of raiding.

To this end, I interviewed 42 current and former state officials in Estonia (14 in semi-structured interviews in 2008 and another 28 in structured interviews in 2014). I also spoke with several attorneys who regularly deal with state officials. When dealing with the subject of corruption, interviews with state officials are not as vulnerable to the survivorship bias as are surveys of businesses; the problem with asking business owners to assess the frequency of corruption is that many who experience the brunt of it disappear from view before the researcher has a chance to interview them. This is far less true of state officials, thereby ensuring a more representative sample of respondents. Likewise, interviews with civil servants are not as subject to the main problem with the other conventional method for measuring corruption - surveys of civil-society experts like NGO specialists, academics, and journalists; I found many such individuals, especially in Poland and Slovakia, to be largely unaware of the actual scale of corruption and related abuses. There were a few notable exceptions, to be sure, and we have heard from these exceptional observers throughout this study. But queries of large numbers of specialists, at least in the four countries considered here, tend to wildly understate the true extent of the problem, as any perusal of the common indices would show (see the discussion in chapter one).

The structured interviews from 2014 were designed to assess the robustness of state institutions in terms of three dimensions. The specific questions appear in Table 7.11 while Table 7.12 provides a breakdown of the respondents by rank and agency affiliation. The first dimension is *bureaucratic integrity*. This refers to whether the hiring of state personnel is based on merit versus personal connections (Question 1) and whether officials are promoted for effectively executing their formal tasks as opposed to demonstrating personal loyalty to their bosses (Question 2). The second dimension is the strength of *institutional constraints on corruption* (Questions 3 to 6). This was assessed by asking respondents to estimate the probability that an official discovered to have taken a bribe would be dismissed. Two scenarios were presented: one in which the bribe has already been officially reported to the relevant authorities and an alternative in which the decision to officially disclose the crime had yet to be made. The third dimension is the *evenness of enforcement*. The system might work differently for the very powerful than for those who lack such influence, a possibility that the second dimension fails to consider. The execution of a raid, after all, does not require the entire state apparatus to be thoroughly corrupt; all the raider needs is access to the right officials at the right time to help the attack go forward. In this vein, Questions 7 and 8 asked respondents to comment on the ease with which an especially well-connected individual, such as a prominent businessperson, can corruptly influence an official decision.

The discussion below not only covers the 2014 interviews but also, where appropriate, incorporates responses from the 2008 interviews; both sets of interviews were broadly similar in the subjects they addressed.

The collective evidence they present is overwhelming: the civil servants with whom I spoke almost universally affirmed the honesty of their colleagues and the

Table 7.11 . Structured Interviews with Estonian Civil Servants (2014): Questions

1. Are personnel in your agency more likely to be hired on the basis of:
 - Their professional competence
 - Their personal connections
 - Competence and connections are equally important in hiring decisions

2. Are personnel in your agency more likely to be promoted for:
 - Carrying out their lawful tasks
 - Demonstrating personal loyalty to their bosses
 - Both practices are equally likely to be rewarded

3. If a high-ranking official in your agency is discovered to have taken a bribe, and the incident has been reported to the relevant authorities, what is the probability that he or she would be fired?
 - 0-25%
 - 25-50%
 - 50-75%
 - 75-100%

4. Let's say the bribe has been discovered by someone but has not yet been reported. What is the probability that it would be reported and result in the person's dismissal?
 - 0-25%
 - 25-50%
 - 50-75%
 - 75-100%

5. If a middle- or low-ranking official in your agency is discovered to have taken a bribe, and the incident has been reported to the relevant authorities, what is the probability that he or she would be fired?
 - 0-25%
 - 25-50%
 - 50-75%
 - 75-100%

6. Let's say the bribe has been discovered by someone but has not yet been reported. What is the probability that it would be reported and result in the person's dismissal?
 - 0-25%
 - 25-50%
 - 50-75%
 - 75-100%

7. If an especially well-connected individual, such as an influential businessperson, wants to corruptly influence a decision made by a high-ranking official in your agency, how easy would this be to achieve?
 - Very easy
 - Moderately easy
 - Difficult, but possible
 - Nearly impossible

8. If an especially well-connected individual, such as an influential businessperson, wants to corruptly influence a decision made by a middle- or low-ranking official in your agency, how easy would this be to achieve?
 - Very easy
 - Moderately easy
 - Difficult, but possible
 - Nearly impossible

robustness of Estonia's state institutions. Their answers provide a strong indication that its property rights institutions have become highly effective and authoritative.

Bureaucratic Integrity

Practically all officials confirmed the high bureaucratic integrity of the Estonian state. All but one agreed that hiring decisions are made primarily on the basis of the candidate's merit; the single dissenter reported that qualifications and connections matter equally in appointments. As for winning promotion, only two answered that merit and loyalty to one's superiors are equally important; all others stressed that personal loyalty plays no role at all (note: one other respondent did not answer the question, believing it to be irrelevant as promotions in her ministry are very rare). The only exception to this rule is the appointment of actual ministers, who tend to be political in every country; all other appointments are reserved for career professionals. One of the two respondents who answered that promotion decisions are based equally on professional effectiveness and loyalty to one's superiors is Ranno Aednurm, who serves in the Audit Department of the Tax & Customs Board. However, he qualified his answer: "the higher you are [i.e. at the level of department heads and above], the more importance is placed on loyalty. But the most important thing, I think, is whether you have new ideas and the way you express these ideas. If you can convince your superior of your ideas, you can get promoted, even if you are not so loyal. In lower positions, it's more important how capable you are in your work."¹⁹⁹

Furthermore, the career professionals who serve in the Estonian state administration are protected from the threat of mass purges following a change of power. "I'm quite sure that hiring decisions are based only on professionalism," asserts one state prosecutor. "The hiring process doesn't allow for the use of personal contacts." Promotion is similarly based on merit only, this source believes; "I cannot 100-percent exclude that loyalty plays a small role, but when I think about all the people who have been promoted over the course of my career, it has all been done on the basis of their personal achievements."²⁰⁰ The other prosecutors agree on this point. "If you don't have the qualifications, you have no possibility of working here," an assistant prosecutor claims.²⁰¹

Attempts to ram through political appointees meet stiff resistance and usually result in failure. Andres Anvelt, the former Director of the Central Criminal Police and a current MP, recalls one such scandal. "Last year, when the term of the last Director General of the police ended, the position was empty for half a year because the Interior Minister was trying to put in place a political appointee. But the reality is that, most of the time, it is hard to do this because the media will kill this person politically. In the end he was not able to put the person he wanted in the position. The new leader of the police came from inside the organization and was not the minister's choice." During the 1990s there was considerable turnover in the leadership of the police, which created instability among the ranks. However, Anvelt says, "since then everyone has served their full five year term, even as governments have changed. This shows that the politicians haven't

¹⁹⁹ Interview with Ranno Aednurm, 11 June 2014.

²⁰⁰ Interview with source, 2014.

²⁰¹ Interview with source, 2014.

Table 7.12. Structured Interviews with Estonian Civil Servants (2014): Snapshot of Respondents

Total Number of Respondents:	28
Civil Servants	27
Attorneys	1

Civil Servants by Rank*

High-Ranking	13
Middle- & Lower-Ranking	14
Total	27

**High-ranking officials: department heads and above in the ministries; directors and deputy directors in the police; state prosecutors; judges of the second-instance or above*

**Middle- & lower-ranking officials: anyone below department head in the ministries; assistant prosecutors; first-instance judges*

Respondents by Agency

Police	3
Prosecutors	3
Judges	3
Ministry of Economy	2
Ministry of Environment & Related	3
Ministry of Finance	7
Ministry of Justice	2
Ministry of Social Affairs	2
Tax & Customs Board	2
Private Attorneys	1
Total	28

even tried [to make political appointments] – maybe they tried but nothing happened...It’s not easy for politicians to do this sort of thing because it will ruin their political careers.” Even at lower levels - in the police districts, for example - hiring is done on the basis of competence rather than connections. “In the last ten years I haven’t noticed any instances of some district police chief hiring his cronies,” Anvelt reports.²⁰²

Mati Ombler, the head of the Anti-Corruption Bureau of the Central Criminal Police, reiterates this point. “In the national police as a whole [as well as the Anti-Corruption Bureau], education and experience are the most important factors” in hiring decisions. “Personal connections have no importance. We don’t want those people because the results of misusing such connections in their work are not what we would expect of them...and there is a risk of corruption as well.”²⁰³

Although there have been a few isolated cases of corruption in the judiciary, most judges with whom I spoke consider their colleagues to be highly professional. Pavel Gontšarov, a criminal judge in the Tallinn Court of Appeals, makes a point of emphasizing this. “It is very clear - appointments of judges have nothing to do with

²⁰² Interview with Andres Anvelt, 28 February 2014.

²⁰³ Interview with Mati Ombler, 7 March 2014.

connections; the only consideration is the professionalism of the judge and his ethical qualifications.” He notes the onerous formal procedures through which any candidate for judicial appointment must pass. To begin with, all appointments are filled by open competition. Candidates must first pass a difficult examination held over three days and evaluated by a committee of judges and other legal professionals. Eligibility to even take the exam requires at least two years of experience as a prosecutor or attorney. If the candidate manages to pass, he or she must then undergo an invasive background check by the Security Police. If the background check proceeds without issue, the candidate is interviewed by the Examination Board. The Examination Board then makes its recommendation to the Supreme Court, whose members interview the candidates and choose one to propose to the President. “It’s almost impossible to convince the 19 members of the Supreme Court to appoint someone on the basis of political connections,” Gontšarov adds.²⁰⁴

That said, he does note a recent report by GRECO, the Council of Europe’s anti-corruption body, that criticizes the system of promoting Estonian judges. GRECO’s complaint centers around its finding that the system is insufficiently transparent and not subject to clearly-defined rules. In a society where corrupt business elites proliferate, they might easily exploit such institutional deficiencies to ensure the promotion of pliable judges. This does not happen in Estonia for the simple reason that the kinds of economic predators who would attempt to manipulate the system are largely consigned to the margins. Despite the procedural flaws noted by GRECO, “even up to this point judges have been promoted only for performing their duties well,” Gontšarov says. “I firmly believe this to be true. I’ve been working as a judge for 13 years and cannot think of any examples where I would even expect that someone was appointed based on personal loyalty. I am 100-percent positive that these decisions are based on professional skills and not loyalty.”²⁰⁵

This is a perfect example of how the institutionalist literature may overstate the significance of transparent rules. Transparency is surely a good thing. But if corrupt businesspeople rule supreme, rules stipulating greater transparency are unlikely to be adopted or work as intended. If corrupt actors are sidelined, the outcomes that transparency is designed to produce are likely to obtain anyway.

Anneli Sihver, an adviser at the Ministry of Finance, offers another example of how Weberian-bureaucratic norms arose even before they were formally coded into law. She notes how, before the new Civil Service Act was passed in 2012, public competitions for filling vacant state positions were required only in certain cases, not universally as they are now. Consequently, “possibilities for hiring those whom you personally preferred were higher,” she concedes. “But even before the new law, the Ministry of Finance based its recruitment on professional experience. It’s pretty hard to hire someone in Estonia on the basis of personal connections - at the state level, at least.”²⁰⁶

“It obviously helps if someone can recommend you,” says Taivo Põrk, a lawyer at the Finance Ministry who previously worked at the Tax & Customs Board. “But it can not replace competence. I can’t really think of any cases where someone without necessary skills was hired purely based on connections. At most, there are a few posts,

²⁰⁴ Interview with Pavel Gontšarov, 13 March 2014.

²⁰⁵ Interview with Pavel Gontšarov, 13 March 2014.

²⁰⁶ Interview with Anneli Sihver, 26 March 2014.

such as personal advisor to the Minister, where ‘competence’ and ‘connections’ overlap somewhat.” Once hired, nobody can count on demonstrations of personal fealty to gain them promotion. “Merely being a sycophant won’t get one promoted. Again, performance usually comes first. In my experience, being able to voice constructive criticism of superiors tends to be valued rather than frowned upon,” says Põrk.²⁰⁷

Nor is it feasible to dismiss civil servants on political grounds. “Of course, in any organization people sometimes engage in intrigue or smear others. But it’s not that simple; you can’t just fire someone for personal reasons,” Anvelt says of the police. “The person will go to court; it happens sometimes. And if the reason for the dismissal is not lawful, the court will reinstate this individual. There are dozens of cases in a given year in which dismissed police are fighting their dismissals in court.” He cites one exceptional case in which a high-ranking official in the Security Police was jailed for writing false critical reports on behalf of criminals in an attempt to marginalize certain undesirable investigators. “He was very foolish to do this because Internal Affairs well understood that these reports weren’t right. He was caught very quickly and his assets were confiscated.”²⁰⁸

Constraints on Corruption

As with bureaucratic integrity, practically all respondents agreed that institutional constraints on corruption are very high. Two individuals in the 2014 interviews did not answer the question, but the reasons they gave for their refusals confirmed the predominant view of the others that corruption is extremely rare. The first believed the scenario described – of an official discovered to have taken a bribe – to be so inconceivable as to render irrelevant the question of whether the perpetrator would be dismissed. Likewise, the second respondent declined to answer on the grounds that no incident of alleged bribery had ever occurred at his ministry, thus making it difficult to determine what would happen to a ministry employee who actually was suspected of bribery.

All 26 who answered the question believed that any civil servant, whatever her rank, would be dismissed if evidence surfaced that she took a bribe *and* the information had already been reported. In the event that someone had become aware of the incident but had not yet reported it, 24 of 26 respondents expressed a high level of confidence – estimating a probability of 75 to 100 percent – that it would indeed be reported to the proper authorities in due course and subsequently result in dismissal. Those 24 all deemed it extremely unlikely that a superior who discovered a subordinate to have taken a bribe would subsequently try to conceal the incident.

One of the two who departed from this consensus was Sihver, the Ministry of Finance official who also happens to be an expert on whistle-blowing (having written her master’s thesis on the subject). On the one hand, she believes that a bribery allegation that became public would surely result in the firing of the perpetrator. But she is less convinced that the incident would be reported in the first place; “Estonians are not keen on whistle-blowing,” she cautions.²⁰⁹

²⁰⁷ Interview with Taivo Põrk, 9 June 2014.

²⁰⁸ Interview with Andres Anvelt, 28 February 2014.

²⁰⁹ Interview with Anneli Sihver, 26 March 2014.

Nevertheless, the views of Sihver and the other dissenter must be considered in light of the 24 other civil servants to whom the question was put; all agreed that any incident of suspected bribery would indeed be reported and result in the firing of the perpetrator. Anvelt, the former Central Criminal Police chief, is not one to whitewash Estonia's record on corruption; as an MP, he has been closely involved in efforts to strengthen the country's anti-corruption rules. But he describes a no-tolerance approach to bribery within the police. Anyone suspected of it, he insists, would be suspended pending an investigation and, if the allegations proved true, would be fired (and prosecuted). He considers cover-ups inconceivable. "Attempts to conceal such crimes don't happen. It is theoretically possible, but now our police force is made up of very well-qualified people hired for their professional competence. So these corrupt schemes may work for half-a-year but they will eventually come out; somebody will discover it and report the information."²¹⁰ An assistant prosecutor who wishes to remain anonymous echoed this opinion; "even if the incident hasn't been made public yet, the superior would definitely report it and the person would be dismissed."²¹¹ "All of our superiors would report the incident and begin the investigation," notes a state prosecutor who similarly requested anonymity.²¹²

Carri Ginter, a prominent lawyer with years of experience in both the civil and criminal courts, agrees. "Such matters will definitely be made public if they are serious; they won't be covered up... Maybe drinking on the job might remain hidden, but these things happen anyway." He regards the Security Police, which is responsible for investigating corruption in the judiciary, as unassailably professional; the Security Police "is completely independent of the judiciary and very much independent of political influence. If they catch someone red-handed, it's very likely the person will be prosecuted, regardless of whether he or she has a high-level or low-level position."²¹³

Ombler, who runs the police's Anti-Corruption Bureau, confirms this point. "A criminal case will be opened. If the suspect holds a higher-level position, the case will be investigated by the Security Police and the person will be prosecuted by the State Prosecutor. There is no other option." Cover-ups are next-to-impossible, he says. This is true not only in the Central Criminal Police but other central government agencies as well. "In other agencies besides the Central Criminal Police, I can't guarantee that it's a 100-percent probability [that the crime will be reported and result in dismissal], but it's very close to that," he believes. "In the Tax and Customs Board, for example, these kinds of people are not wanted... It's the same thing in the Competition Authority, the Security Police, and most every other state agency."²¹⁴

As for the judiciary, the few publicized cases of corruption have involved lower-court district judges of the first-instance. "There has never been a case where a high-level judge [of the second-instance or Supreme Court] was even suspected of taking a bribe," Gontšarov notes. He regards corruption as exceedingly rare even in the first-instance courts. "In some small jurisdiction you never know whether or not local politicians might try to influence court decisions... But I'm still quite sure that it's nearly

²¹⁰ Interview with Andres Anvelt, 28 February 2014.

²¹¹ Interview with source, 2014.

²¹² Interview with source, 2014.

²¹³ Interview with Carri Ginter, 14 March 2014.

²¹⁴ Interview with Mati Ombler, 7 March 2014.

impossible.”²¹⁵ Mari-Liis Sööt, an anti-corruption specialist at the Justice Ministry, confirms the seriousness with which any suspicions of corruption would be handled in the agency. She cannot imagine that anyone would try to cover up the crime. “I think people very well understand that corruption is not tolerated here.”²¹⁶

Respondents in other ministries expressed the same view. “I think the bribe attempt would be reported,” according to one Ministry of Finance official. “Maybe there would be some discussion with the minister beforehand, but if it were a definite case of bribery it would certainly be reported” and the perpetrator dismissed.²¹⁷ Põrk, also from the Finance Ministry, backs up this assessment; “it would obviously depend on the superior, but the risk of becoming complicit would be rather high, so I think a cover-up would be unlikely.” He adds that, “while I know of people who have been dismissed in comparable cases, I don’t remember any instances where a superior was discovered afterwards of turning a blind eye.” Põrk recalls one case in which an emergency worker at the Estonian Rescue Service (part of the Interior Ministry) was actually fired for stealing a roll of toilet paper and some air freshener. “That’s pretty extreme, and I would doubt if there weren’t other reasons for getting rid of him. But, still, it illustrates the expected level of integrity,” he says.²¹⁸

Even the traffic police, which in most post-communist countries is notorious for soliciting bribes, is no longer known to accept money from Estonian drivers. “Today, it would be a very foolish person who tries to bribe the traffic police,” Anvelt says.²¹⁹

However, the situation is quite different in the municipalities. “In the smaller districts, the administration is not very professional and local officials can cover up each other’s crimes,” according to Anvelt. “We have a lot of work to do in this field.” The main problem is a lack of sufficient numbers of qualified candidates to fill the positions. Even in the larger cities, like Tallinn, corruption remains a problem.²²⁰ Ombler agrees. “If you’re talking about municipalities - somebody finding out about a bribe, using municipal assets, or stealing money - then it could be different.” On the local level, he regards the prospect of dismissal for corruption as a 50/50 proposition. Nevertheless, “I think it is improving every year because our media and public opinion has become more intolerant of corrupt officials. Nobody wants them inside our ministries, agencies, or municipalities. Luckily, this attitude characterizes the officials themselves.”²²¹

Evenness of Enforcement

Respondents were universally agreed on the evenness of rule-enforcement, the third dimension under consideration. Asked about the prospect that an especially well-connected individual could corrupt an official decision, all respondents who answered reported that it would be either “difficult” or “nearly impossible.” Commenting on the

²¹⁵ Interview with Pavel Gontšarov, 13 March 2014.

²¹⁶ Interview with Mari-Liis Sööt, 4 April 2014.

²¹⁷ Interview with source, 2014.

²¹⁸ Interview with Taivo Põrk, 9 June 2014. For more on this story, see Oliver Kund, “WC-paberi varguse katse viis päästjalt ameti,” *Postimees*, 14 February 2014 (<http://www.postimees.ee/2696614/wc-paberi-varguse-katse-viis-paastjalt-ameti>).

²¹⁹ Interview with Andres Anvelt, 28 February 2014.

²²⁰ Interview with Andres Anvelt, 28 February 2014.

²²¹ Interview with Mati Ombler, 7 March 2014.

possibility of bribing a high-ranking official, 55 percent deemed it nearly impossible while the other 45 percent stated that it would be difficult but possible. As for bribing middle-or-lower ranking officials, the breakdown was similar – 57 percent and 43 percent, respectively. None believed it to be even moderately feasible. Every respondent from both the 2008 and 2014 interviews affirmed that bribing an Estonian official of any kind is, at best, highly risky to attempt and extremely difficult to pull off. (One person declined to provide an answer about the ease of bribing a lower- or middle-ranking civil servant; they lack the authority to decide on any matter of importance and so would never be approached in the first place.)

The bribery of judges is not entirely unheard of in Estonia. Several judges have been prosecuted for corruption over the years. These included Ain Truu, who pled guilty in 2003 to charges of issuing a favorable ruling in exchange for a bribe; Ardi Shuvalov, convicted in 2008 of accepting a bribe in return for granting a lighter sentence; Vambola Olli, found guilty in 2010 for favoring an acquaintance in one case and accepting a bribe in another; and Jüri Sakkart, a Viru County judge also convicted in 2010 for allegedly releasing information to suspected criminals regarding an ongoing police investigation.²²²

These few exceptions aside, however, every judicial official with whom I spoke expressed no misgivings about the integrity of their colleagues. “When something is going on you can usually smell the smoke. But here there is really no smoke,” argues Sööt, the anti-corruption specialist at the Justice Ministry. “There are no newspaper articles on it, for example. So I don’t think there is a big problem.”²²³ “If you are a businessman who wants to bribe a judge, you cannot expect it to be very easy,” claims Tanel Kalmet, also at the Justice Ministry.²²⁴ Heili Sepp, another Justice Ministry official and herself a former prosecutor for the southern region, reiterates this point: “I would be very surprised if people considered it quite safe to go to a judge and offer something... It’s not ordinary to go to a judge, offer to bribe him, and expect to get out of the room safely. Maybe I’m naïve, but I think the judge would call the police.”²²⁵

Gontšarov, himself a judge, confirms how difficult it is to bribe Estonian judges; “nobody can influence any kind of decision [on the part of a judge]. I would absolutely exclude it. I’m not aware of cases where anyone at all would get phone calls or get approached by high-ranking politicians.” He recounts one particularly high-profile case over which he presided:

²²² Kai Joost, “Judge suspected in bribery,” *Baltic Reports*, 9 February 2010; “Summary,” *Äripäev*, 25 March 2003 (<http://www.Äripäev.ee/2360/free/summary.html>); Shuvalov v. Estonia, (European Court of Human Rights, Fifth Section 2010); Bureau of Democracy Human Rights and Labor, *2010 Human Rights Report: Estonia* (Washington: U.S. Department of State, 2011). Available at <http://www.state.gov/j/drl/rls/hrrpt/2010/eur/154422.htm>. Also see Vello Pettai and Martin Mölder, “Estonia,” in *Nations in Transit 2011: The Authoritarian Dead End in the Former Soviet Union* (Washington: Freedom House, 2011). Available at <http://www.freedomhouse.org/report/nations-transit/2011/estonia>. Also see International Association of Anti-Corruption Authorities, “The Security Police”, International Association of Anti-Corruption Authorities. Available at http://www.iaaca.org/AntiCorruptionAuthorities/ByCountriesandRegions/E/Estonia/jigou/201202/t20120209_801468.shtml. Also see Security Police of the Republic of Estonia, *Annual Review 2010* (Tallinn: Security Police of the Republic of Estonia, 2010). Available at <https://www.kapo.ee/cms-data/text/138/124/files/kapo-aastaraamat-2010-eng.pdf>.

²²³ Interview with Mari-Liis Sööt, 5 September 2008.

²²⁴ Interview with Tanel Kalmet, 10 September 2008.

²²⁵ Interview with Heili Sepp, 17 September 2008.

I've been on a court where we were investigating cases against sitting ministers. We were never approached by political parties or interested persons. And that was a tremendously serious case in the history of Estonian political life. We were trying two ministers at the same time (actually ex-ministers, being that they had already been dismissed). Both were powerful and remained MPs in parliament. This was a very, very public case that got a lot of attention. Even so, I didn't feel any kind of inappropriate influence or, indeed, any influence or interest from others at all. Everyone respected the autonomy and integrity of the court and understood that they could not influence the outcome.²²⁶

"I'd say both our court system and prosecutorial system are pretty clean," a source at the Interior Ministry told me in a 2008 interview. "We have problems, of course, but I don't think it would be easy to give some money to a judge and expect to get the decision that you want."²²⁷ The lawyers with whom I spoke affirmed just how rare judicial corruption is in Estonia. "A judge here is not going to risk his job by taking a bribe," says Anton Sigal. "The press is very active in uncovering corruption and would put pressure on law enforcement to act if anything was discovered."²²⁸ Peeter Lepik echoes this view: "I wouldn't be able to tell anyone that you can just find the right judge and we'll handle it that way."²²⁹

As hard as it is to influence judges, bribing prosecutors is equally infeasible, according to my respondents. Sepp insists she was never offered a bribe while she worked as a prosecutor. In fact, at one point she considered going into the private sector but ultimately decided to remain in the civil service. Her reluctance to take a job with a private firm stemmed from her concern that she might come under pressure from her superiors to break the law. "I know I would never be pressured in this way working for the state. I just trust the state system so much more," she says.²³⁰

Others reiterate this point. "I am this unhappy person who has never been offered a bribe," reports another longstanding prosecutor. "If it really happened, eventually it would come out. Even simple jealousies would lead someone to disclose it." He points to the Code of Criminal Procedure, passed in 2003, which gives prosecutors expanded discretion to decide which cases to pursue and how to pursue them. Previously, any case in which there existed sufficient evidence to prosecute would automatically go to trial while those lacking adequate evidence would not. Under the new code, the prosecutor can choose among any number of alternatives including a full trial, a plea bargain, or a fine (depending on the severity of the offense). At the time, there was much debate among policymakers regarding whether the proposed changes would give prosecutors too much leeway. However, since the law entered into force in 2004, no reports of any abuses have surfaced. If corruption were really a problem, one would expect to hear at least some complaints of alleged prosecutorial misconduct, the prosecutor notes.²³¹

²²⁶ Interview with Pavel Gontšarov, 13 March 2014.

²²⁷ Interview with Respondent #108.

²²⁸ Interview with Anton Sigal, 6 October 2008.

²²⁹ Interview with Peeter Lepik, 3 November 2008.

²³⁰ Interview with Heili Sepp, 17 September 2008.

²³¹ Interview with Respondent #107; The Code of Criminal Procedure is available in English at <http://www.legislationline.org/documents/section/criminal-codes>.

The experience of Estonia in this regard offers a stark contrast to Poland, where prosecutors enjoy similarly wide discretion and are notorious for abusing it. “It’s not possible in the police force to close a case against a politician or businessman and to have this order come from the Minister of Interior,” Ombler claims.²³²

Many respondents attribute this fact to the need to bribe multiple officials in order to attain the desired result, something they consider next-to-impossible. “If you want to pay a bribe to influence an investigation,” Anvelt explains, “you not only have to bribe the police officer but the prosecutor too,” since the prosecutor is in charge.²³³ Ombler agrees; “it’s nearly impossible, absolutely. It is not only police officials that are investigating a criminal case but the prosecutor’s office as well... And so the person would need to buy the prosecutor too. It’s not a common occurrence here.” He adds that, “as far as I can remember, in Estonian history we’ve never had a case where both an investigator and prosecutor were bribed at the same time.”²³⁴

Nevertheless, the other countries offered up a multitude of cases where bribes, payoffs, and other favors were clearly dispensed across wide networks of corrupt officials. This points to something more fundamental at work other than the mere number of officials who must be recruited into the scheme. The difficulty in bribing Estonian civil servants instead stems from the general level of professionalism and honesty in the state administration. Whereas corrupt regional networks in Poland often go to great lengths to ensure that officials remain complicit and thus eternally pliable, in Estonia such monitoring has the reverse effect. “I believe it would be very difficult to hide the fact that the bribe was made,” argues a state prosecutor, “since the prosecutor would be making strange decisions and other prosecutors as well as the Security Police Board are keeping an eye on things.”²³⁵ Another state prosecutor repeats this point; “when we get a criminal case it is hard to influence someone here because the police officers who investigated it are aware of the evidence against the defendant. They would sound the alarm to their superiors if they thought anything questionable was going on.”²³⁶ The contrast with Poland could not be any sharper; there, one can easily imagine the alarm being sounded for the very opposite reason - to rein in an honest prosecutor or investigator who is attempting to pursue a case fairly and in accordance with the law.

The prosecutors I interviewed were insistent on the honesty of their colleagues. Asked about the ease with which an especially influential businessperson could bribe one of his kind, a state prosecutor flatly denied it could succeed. “It would be nearly impossible, because I know my colleagues; I know they are honest and would never let anyone influence them.” He admits the possibility may be slightly higher in very small municipalities with only a few thousand inhabitants, but he imagines these to be exceptions.²³⁷ An assistant district prosecutor agrees; “prosecutors don’t take bribes or make their decisions based on some well-connected person’s opinion.”²³⁸ “I haven’t heard of a case where an investigator took a bribe,” Anvelt confirms.²³⁹

²³² Interview with Mati Ombler.

²³³ Interview with Andres Anvelt.

²³⁴ Interview with Mati Ombler.

²³⁵ Interview with source, 2014.

²³⁶ Interview with source, 2014.

²³⁷ Interview with source, 2014.

²³⁸ Interview with source, 2014.

²³⁹ Interview with Andres Anvelt, 28 February 2014.

Those in other ministries expressed similar views; even for an especially influential businessperson, all respondents considered it, at the very least, quite difficult to bribe anyone in their respective agencies. “It depends on the issue, I think,” said one individual at the Ministry of Finance. “In public procurement proceedings it would be nearly impossible. But if the decision concerned a legislative proposal, in which case the procedure might not be as clearly defined, there might be a possibility that someone could influence the wording. So in that case my answer would be ‘difficult, but possible’.” Even so, the respondent notes, if somebody higher up the ladder tried to force through a suspicious change to the wording of a proposed law, those lower down the chain might very well go to the media.²⁴⁰

Another official in one of the ministries believes that, even for someone of great influence, it is rather pointless to try to bribe a civil servant, either in the ministry itself or any of the related regulatory agencies. The reason is that each draft rule, regulation, and law must pass through multiple hoops before it is finally enacted, with large numbers of people able to voice their input. Moreover, the process is completely transparent; all comments and proposals are recorded in an electronic database. Anyone who tries to insert a questionable provision must therefore be prepared to explain the rationale behind it. The same is true for the granting of regulatory approvals. “If we are talking about using your influence to speed up the process of getting a permit, then it is certainly possible to try. But the civil servant has to follow the procedures anyway. This means his or her supervisor is looking at all the activity, again through the electronic system, and he or she must review the permit application within a certain period of time. So they cannot speed it up too much – say, to one hour or even one day – because it is not professional and, again, it is possible to observe the record in the electronic system.” There are also periodic internal audits of decisions issued by the ministry and its related agencies. “So somebody can *try* to make an approach but it is not easy to get results.”²⁴¹

Clearly, then, the fact that the rules are so well-designed – transparency, input from multiple participants, audits, etc. – makes it difficult to corrupt state personnel. But such well-designed rules were not always in place, particularly in the 1990s. The electronic database that records every proposal and amendment submitted during the drafting of a rule is a relatively recent creation. “The process is now more and more open compared to 10 years ago and unbelievably different compared to 15 or 20 years ago,” the same respondent notes. “Fifteen years ago, all you had to do was obtain a certain signature of approval on the second page of the cover letter...Now, it’s on another level. It’s an open process and everyone has certain responsibilities to submit comments through the electronic communications system. And those comments will be in the official record so that, later on, you can look at how it unfolded.” Like the transparent rule-making structure, the extensive use of audits to review regulatory decisions only arose around the time of Estonia’s EU accession, he recalls.²⁴²

And yet, even then, my respondent, who prefers not to be named, recalls few if any attempts to unduly influence the process (he has worked at the same ministry since

²⁴⁰ Interview with source, 2014.

²⁴¹ Interview with source, 2014

²⁴² Interview with source.

1992). “Even before the open system of drafting and commenting on laws was in place, the cases of inappropriate influence were still pretty rare.”²⁴³

What accounts for this? Obviously, it cannot be the capacity of the institutions themselves, as many of the rules and enforcement mechanisms that currently make up this capacity did not yet exist. Instead, the answer lies in the fact that relatively few actors were trying to game the system in the first place. And the reason why few were trying to game the system was because the kinds of actors who *would* attempt to do so – political thugs and crony capitalists – were few in number.

Even investigative journalists, whose very job it is to be hyper-sensitive to any hint of official abuses, expressed to me that bribing state officials in Estonia is difficult to pull off. “If bribery was indeed common, you would hear about it,” says Toivo Tänavsuu, repeating similar statements from many civil servants. “You would always be able to find some rival of the businessman who would go to the media with the allegation. The information would come out somehow, but it doesn’t.”²⁴⁴ Enno Tammer, another journalist, believes it is possible to bribe certain kinds of state officials. But the ones who would really count in assisting a raid tend to remain off limits. For instance, he strongly doubts rumors that the prosecution of Toomas Annus in the land-exchange scandal was orchestrated by the businessman’s enemies. The reason? “The Security Police is behind the investigation, and nobody can influence the Security Police to attack a rival.”²⁴⁵

The country’s courts play a key role in preventing abuses by state officials. “When the Tax Board has been too enthusiastic, the courts have usually ruled against it,” says Peeter Lepik. “This kind of double control makes the state regulatory bodies more careful.”²⁴⁶

Enhancing Estonia’s Institutions: It’s the Criminal Networks, Stupid

Nevertheless, this begs the question as to why the courts in Poland, Slovakia, and Ukraine tend not to perform the same function. The immediate answer is that they are frequently in league with the corrupt networks responsible for the abuses in the first place. The real reason why the system of checks and balances works in Estonia is the relative absence of the corrupt networks themselves. This underscores one of the main points of this study: that the study of the origins of property rights institutions will not get very far unless we analyze how actors shape institutions, not just the other way around.

The fact that these networks never gained much of a foothold in Estonia stems in large part from the mode of transition. Instead of holding onto power, as it managed to do in Ukraine and Poland, the old ruling elite was entirely displaced. As a result, Estonia’s early post-communist governments had free rein to take whatever actions they deemed necessary to prevent the old-boy KGB networks from surviving inside state structures. As Slovakia showed, transition-by-replacement could hardly ensure such

²⁴³ Interview with source.

²⁴⁴ Interview with Toivo Tänavsuu, 30 October 2008.

²⁴⁵ Interview with Enno Tammer, 5 November 2008.

²⁴⁶ Interview with Peeter Lepik, 3 November 2008.

measures would actually be taken. But it was arguably a precondition. And in contrast to Slovakia, Estonia's leaders would seize the opportunity.

In the early days of independence they initiated a formal vetting process whereby officials with links to the KGB or otherwise complicit in repressive activities were dismissed from office. (Many Russian-speakers who lacked adequate Estonian language skills faced the same fate, although this likely had no impact on the extent of corruption afterward.) Ain Truu, one of the only post-communist judges found to be corrupt, is an exception that proves the rule. After he was charged, it emerged he had once worked for an association of Soviet-era police officers and continued to have links with it even after becoming a judge. "So it is clear they didn't check him strictly enough," says Helve Särgava. Shedding light on the thoroughness of the post-independence vetting process, she notes that Truu was appointed only in the late 1990s, well after process had run its course.²⁴⁷

The vetting program was led by the Ministry of Justice. It focused on those agencies with a long history under Soviet rule and which continued operating in the post-communist period (as opposed to the new bodies that had been created starting in the late 1980s). Prominent among these were the police, courts, and prosecutors' offices. The task of identifying and rooting out persons suspected of corruption or disloyalty to Estonia was relatively clear-cut. "Everybody knew who had cooperated with the KGB," recalls Alar Kirs, a Soviet-era prosecutor and investigator who continued working in the General Prosecutor's Office after independence. Others were of "poor character, lazy, or incompetent," he notes.²⁴⁸

Among judges, competency was not an issue since the Soviet system had strict mechanisms in place to weed out those who were not up to the task. But the vetting process certainly did reach the courts. A special commission was established under the auspices of the Justice Ministry. It included judges from all levels of the court system, from the first-instance courts to the Supreme Court. The committee issued its recommendations to the general assembly of the Supreme Court, which in turn decided which candidates to recommend to the President, who was given final responsibility for judicial appointments. "The aim was to have judges with good reputations who were loyal to the Republic of Estonia," explains Särgava, who served on the commission.²⁴⁹

In the end, there was a "big clean-out" of questionable judges, as prosecutor Kristel Siitam-Nyiri describes it, with many new judges and prosecutors being hired.²⁵⁰ "Very often, these judges were disqualified just based on the *suspicion* that they might be disloyal [to the new republic]," Särgava recalls. "It may be that some people were disqualified unfairly. It was a very strict process." However, there were no mass purges. Only 10 percent of dismissals during the vetting process were prompted by any allegedly compromising political links on the part of the judge; the vast majority related to insufficient language qualifications. Most judges who wished to keep their jobs could so long as they were not complicit in communist-era political activities and had adequate knowledge of Estonian.²⁵¹

²⁴⁷ Interview with Helve Särgava, 6 November 2008.

²⁴⁸ Interview with Alar Kirs, 9 October 2008.

²⁴⁹ Interview with Helve Särgava, 6 November 2008.

²⁵⁰ Interview with Kristel Siitam-Nyiri, 15 September 2008.

²⁵¹ Interview with Helve Särgava, 6 November 2008.

But had the Laar government not stuck so steadfastly to its policy of hard budget constraints, a new class of economic criminals could have arisen to place their allies back into state positions. This is precisely what happened in Slovakia under Mečiar and is the main reason why its property rights institutions remained stymied to this day.

In fact, one of the most telling consequences of the deficit of political thugs and crony capitalists in Estonia is the continual improvement in the robustness of its state institutions. Recall the experiences of the other three countries, where soft budget constraints, the ascendance of political thugs, and weak property rights institutions reinforced each other through feedback effects. Poland provides an especially sharp illustration of this phenomenon; as economic predators gained increasing wealth and power in the 1990s, they spurred a dramatic trend toward the creation of overly burdensome regulations in order to shape the playing field to their own advantage. In Estonia, one can observe feedback effects working in the opposite direction. The relative lack of political thugs and crony capitalists allowed effective property rights institutions to take root. This further marginalized corrupt business actors and, in turn, allowed for further enhancements to the integrity of state institutions.

For instance, in 2002 the Penal Code was markedly strengthened to allow for the effective prosecution of corruption-related crimes. At the same time, the 1999 Anti-Corruption Law, which dealt with more specific offenses, remained a “mess,” as Mari-Liis Sööt put it. Filled with vague provisions and loopholes, the act “was a reflection of the kind of corruption we had in the 1990s - petty corruption, not the kinds that are most serious today” such as party financing and high-level involvement in illegal trafficking. Furthermore, the law’s definition of who is and is not considered a public official was excessively restrictive. This limited the range of officials subject to requirements on conflicts-of-interest and asset-declaration.²⁵²

However, in 2008 the Justice Ministry adopted a tough new Anti-Corruption Strategy. An even tougher revised version followed in 2013.²⁵³ Sööt explains the key changes. “In the old law, the definition [of a public official] was vague, and there was a closed list of people to whom it applied - the Legal Chancellor, the State Auditor, etc. This meant that if a new legal office was created which was not on the list, the person appointed to the position was exempt from the rules. Now we no longer have a closed list. We have an open definition; almost any legal person who makes decisions is considered a public official under the law. It doesn’t even depend on whether you receive remuneration for your services; you are still a public official and you have to comply with the rules.”²⁵⁴

Another flaw in the old law was that it placed all responsibility for enforcement supervision in the hands of the Justice Ministry; other state agencies had no obligation to ensure their employees’ compliance. “The aim of the new law is to decentralize

²⁵² Interview with Mari-Liis Sööt, 5 September 2008.

²⁵³ The 2008-12 Anti-Corruption Strategy is available at <http://www.just.ee/orb.aw/class=file/action=preview/id=35712/ANTI+CORRUPTION+STRATEGY+2008-2012.pdf>. The 2013-20 Strategy is available at <http://www.korruptsioon.ee/et/korruptsioonivastane-tegevus-eestis/korruptsioonivastane-strateegia-2013-2020>. In 2012, the Anti-Corruption Act was formally amended to correct its previous shortcomings. The 2012 Act is available at http://publicofficialsfinancialdisclosure.worldbank.org/sites/fdl/files/assets/law-library-files/estonia_anti_corruption_act_2012_en.pdf.

²⁵⁴ Interview with Mari-Liis Sööt, 4 April 2014.

corruption-prevention so that each state agency understands that anti-corruption activities are their own child and not just a child of the Justice Ministry; each agency must now take responsibility for raising that child.” The revised law also reduces the incentives for officials to violate conflict-of-interest rules. More fundamentally, the new Anti-Corruption Strategy has shifted the Justice Ministry’s efforts away from simply responding to corruption and towards prevention. “Instead of targeting corruption itself, we now orient our activities around priority ‘focus areas’. This way, we can minimize opportunities for corruption by analyzing certain processes where, because of insufficient transparency, corruption remains a danger. We can then reduce those opportunities by increasing transparency in those areas.”²⁵⁵

Anti-money laundering (AML) law is another domain that has seen continual improvements over time. As a tiny, politically stable country situated next door to an enormous and highly criminalized economy (Russia), Estonia faces heightened money-laundering risks than the average EU member. Yet, unlike Latvia and Cyprus, which face similar circumstances, it has not turned into a hub for illicit Russian capital.

The immediate reason why is that its policymakers have consistently gone above and beyond the standard Financial Action Task Force (FATF) recommendations in drafting AML rules.²⁵⁶ “We are currently evaluating our resources and capacity for investigation,” reports Veronika Mets, the senior AML specialist at the Ministry of Finance. “I can’t give us a grade of 100 percent because I don’t believe you can rate any organization that highly; there is always room for improvement. But if you compare us to many other countries, we are doing much, much better,” she claims. “If you look at a map (we are right next to Russia), you can see we are already in a risky position. Yet our regulations are much stricter than European rules and FATF standards, and the reason is that we acknowledge our risks to be higher. If our laws weren’t as strict, our country might have become a center for enormous money laundering, just like Cyprus.” As an example of Estonia’s more stringent rules, she cites the requirement that financial institutions meet face-to-face with all first-time clients. Most of the large banks conform to such practices anyway, but many institutions do not. “This rule has been criticized by firms that want to do business here,” Mets notes, “but we believe we need additional safeguards.”²⁵⁷

Contrast the vigilance of Estonian policymakers to successive Latvian governments which have turned the country into a hotbed for Russian dirty money. In early 2014, JP Morgan entirely shut down its money-clearing services in Latvia after complaints from US regulators and Global Witness, the non-governmental watchdog.²⁵⁸

The reason behind the different approaches of the two countries likely lies in the character of their respective business elites. Latvia, which has attracted considerable

²⁵⁵ Interview with Mari-Liis Sõöt, 4 April 2014.

²⁵⁶ To access the Estonian Money Laundering and Terrorist Financing Prevention Act, go to <https://www.riigiteataja.ee/en/eli/523122013005/consolide>. For the assessment of Estonian AML laws by MONEYVAL, the relevant Council of Europe body, go to http://www.coe.int/t/dghl/monitoring/moneyval/Countries/Estonia_en.asp.

²⁵⁷ Interview with Veronika Mets, 14 May 2014.

²⁵⁸ Aaron Eglitis, “JPMorgan Halts Latvia Dollar Deals After Probes, Group Says,” *Bloomberg*, 2 January 2014.

notoriety of late for its high corruption,²⁵⁹ most certainly contains a far higher proportion of political thugs and crony capitalists. Such economic predators help ensure the appointment of state officials of far less integrity than Estonia's, making meaningful improvements to AML law much more difficult to attain.

A further example of the continual enhancements in state institutions is the Political Parties Act. It was amended in 2012 following a major party financing scandal that resulted in the resignation of the Justice Minister. In Poland, similar scandals and calls for legislative improvements are met with government stonewalling. However, the Estonian President responded by establishing a public forum to solicit proposals for strengthening the rules. Sööt is cautiously optimistic on the resulting amendments to the Act; "I think there have been improvements but it remains a high-risk area... There have been some changes to the Political Parties Act, and these changes came into effect quite recently." She goes on to explain the specific changes. "There is now an upper limit on cash donations from a single person as well as prohibitions to prevent the misuse of public funds by parties for political purposes." She also points to limited improvements in the capacity to audit and investigate parties' declarations of their financing sources. "Now there is a body in the parliament which is not composed of parliamentary deputies, as it was before. Rather, each party can appoint a member to the body, and they have appointed very well-known people who are independent of any party affiliation." Nevertheless, to this day no official agency is examining the finances of political parties in any systematic way.²⁶⁰

There are plenty of other examples of Estonian lawmakers strengthening laws and regulations as weaknesses become apparent. The rule requiring the presence of a notary at any board meeting that results in a change to the company's directors was adopted following a scandal at a Tallinn hotel.²⁶¹ In 2012, parliament adopted a new Civil Service Act that requires all vacant posts in the state administration to be filled through competitions. Whether the competition is open to the public or conducted internally, a fair competition must be held regardless and the announcement distributed widely. This applies not only to new appointments but also to promotions; nobody can be promoted any longer in the absence of a real competition.²⁶²

While problems will always remain, one is struck by the concerted efforts of Estonian policymakers to continually identify and fix them. The contrast with Poland, Slovakia, and Ukraine could not be more apparent. The reason why Estonia stands so far ahead of the other countries in this regard is that there are fewer political thugs and crony capitalists with sufficient influence to stymie such initiatives. The comparative ease with which improvements can be made only serves to underscore the main point of this study: that efforts to build property-rights institutions will falter unless adequate steps are taken to marginalize the economic predators bent on undermining them. Much of the recent literature tends to look at how institutions shape actors. But unless we examine how the

²⁵⁹ Alexandru Rusu, *A Diagnosis of Corruption in Latvia* (Berlin: European Research Centre for Anti-Corruption and State-Building (ERCAS), 2010). Also see "Throwing Mud, Finding Dirt," *The Economist*, 15 March 2011.

²⁶⁰ Interview with Mari-Liis Sööt, 4 April 2014.

²⁶¹ Interview with Katrin Prükk, 7 October 2008.

²⁶² For the text of the law, go to

<http://www.legaltext.ee/et/andmebaas/tekst.asp?loc=text&dok=2013X11&keel=en&pg=1&ptyyp=RT&tyyp=X&query=avaliku+teenistuse>.

nature of the actors drives institutional outcomes, we are missing a major piece of the puzzle.

In the absence of powerful networks linking economic predators to officialdom, Estonia has likewise had an easy time making its rules and procedures ever simpler and more transparent. The country has been widely noted for this achievement. One reason why Anton Sigal believes such criminals cannot use state institutions to raid others is the absence of heavy-handed state regulation. Citing an extreme example, he compares Estonia to Belarus, where his law firm also does business. “In Belarus, factories have to deal with inspections all the time and there are dozens of authorities who have the power to fine you and ultimately shut you down.” This sort of thing is impossible in Estonia, he asserts. Regulations on Estonian businesses tend to be highly streamlined. Additionally, the state agencies tasked with overseeing businesses are few in number and employ career professionals rather than political appointees. To take but one example, the Civil Aviation Authority, which oversees the airline industry, “has been staffed by the same professionals who have been working there for 10 years. As a result, it is difficult for businessmen to find connections in the agency. The competition board is the same way.”²⁶³

Kadri Väling, a prosecutor who used to handle customs-related cases, reports that foreign companies who must export goods from Russia often choose to do so through Estonia. The reason is that “here, the goods are less likely to be taken hostage by corrupt customs officials looking for a bribe.” Often times, they simply establish subsidiaries in Estonia to handle all of their exporting needs, not just because of the lower corruption but the much simpler process of registering a business.²⁶⁴

In contrast to most other post-communist countries, establishing and registering a business is done entirely online in Estonia, cutting out any opportunities for grasping officials to demand bribes. All notices for public procurements are published online in the State Public Procurement Registry (SPPR).²⁶⁵ This prevents the kinds of shenanigans common to the other three countries (recall the infamous “bulletin-board tender” in Slovakia, in which the only place the official tender notice was posted was in a hallway deep inside the Construction Ministry).

The introduction of the flat tax in the mid-1990s also served to remove opportunities for corruption among officials. “The government is trying to make the system so transparent that if someone is doing something unlawful it will be found out sooner or later,” says Sinisalu. “With the flat tax, for instance, there’s no use trying to hide your assets. If you want to evade taxes, you would have to go live in Switzerland or Monaco.”²⁶⁶

The high transparency of official documentation provides a boon to investigative journalists. “We have good legislation that provides for absolute transparency,” say Erik Gamzejev and Erik Kalda, the Narva journalists who investigated local political thug Nikolai Ossipenko. “For example, the financial statements of all companies are available on the internet. You can look there and see what Ossipenko was doing last year, what his profits were, what he was paying his employees in wages, etc.” Because of the Public

²⁶³ Interview with Anton Sigal, 6 October 2008.

²⁶⁴ Interview with Kadri Väling, 15 September 2008.

²⁶⁵ Kasemets, 27.

²⁶⁶ Interview with Arnold Sinisalu, 7 November 2008.

Information Act, “you can inquire to the local government about how much money was paid to him. Any citizen can ask these questions and get a speedy answer.”²⁶⁷ Passed in 2000, the Public Information Act gives citizens wide access to official documentation. It also established a powerful Data Protection Inspectorate to enforce the act.²⁶⁸ The Polish experience puts into sharp relief the ease with which Estonia’s Public Information Act was enacted. As chapter six showed, Poland’s Civic Platform government launched a vigorous crusade to scuttle the effective implementation of a similar freedom-of-information law, a battle which persists to this day.

While he has few positive things to say about the corrupt elites he has reported on, journalist Mihkel Kärmas lauds the remarkable transparency of the Estonian state. He credits the Public Information Act with helping him break many stories. Among these was one that exposed efforts by local officials in the province of Pärnu to forge documents in order to steal land from unwitting pensioners. He also notes that the land registry, business registry, most court decisions, and all municipal council measures are freely available online.²⁶⁹

Aavo Kokk similarly praises the simplicity and transparency of Estonian business regulations. “It is very easy to run a business in this country. Somebody measured how fast bills are paid, and Estonia is at the top of Europe, ahead of all other countries.” He provides an example of how it works in practice. “Let’s say I go to a shop and buy a tape recorder, for example. I tell them I want my company to pay for it; they should send me the invoice and I’ll pay it later. They’ll just look to see that my company is registered, and in most of cases it’s done,” he explains. “So it is a pretty visible and effective system. I like it.”²⁷⁰

The increasing computerization of state functions has greatly reduced opportunities for corruption. “In the tax agency,” Sinisalu notes, “the internal controls have worked quite efficiently. It’s not so easy to alter documents in the system if you do something you shouldn’t do. If you try, it is quite easy to find out.” The reason is that “everything is now computerized. It’s totally transparent. The computer does a lot of the work itself, and if you start to change something in the system it becomes obvious. For example, to import or export something, the businessman fills in all the documents online. So it would be impossible for a customs officer to demand any bribes; it’s useless to ask for something.”²⁷¹

“I think one of the reasons why Estonia lacks the corruption that many other countries have is the transparency of documentation; all documents are placed in a publicly available system,” says Veronika Mets, a Finance Ministry lawyer. “And unless this information is by law not public, it must be made public so that nothing can be hidden. This is one thing that makes our system transparent to citizens.”²⁷²

²⁶⁷ Interview with Erik Gamzejev and Erik Kalda, 13 November 2008.

²⁶⁸ See Freedom House evaluation of press freedom in Estonia at (<http://www.freedomhouse.org/report/freedom-press/2011/estonia>). Also see FreedomInfo.org (<http://www.freedominfo.org/regions/europe/estonia/>).

²⁶⁹ Interview with Mihkel Kärmas, 22 October 2008.

²⁷⁰ Interview with Aavo Kokk, 14 October 2008.

²⁷¹ Interview with Arnold Sinisalu, 7 November 2008.

²⁷² Interview with Veronika Mets, 14 May 2014.

The fact that Estonian institutions are as transparent as they are is surely a good thing. But it should be viewed as the outcome - not the cause - of a business environment in which political thugs and crony capitalists remain marginalized.

The most high-level prosecution of a corrupt network in Estonia occurred in the wake of the land-exchange scandal and ultimately netted the former Environment Minister, as noted earlier. “The land exchange case is an important step because it shows that nobody is untouchable, no matter how senior the position,” says Sinisalu.²⁷³

Others question this view. “Can we prosecute people from the governing parties? This is not so clear,” says Mari-Liis Sööt. While there have been some notable prosecutions, “there are fewer high-level cases than are probably warranted.”²⁷⁴ A 2008 Transparency International report noted that “[h]igh-level corruption cases, [including those relating to] corruption networks have not been handled sufficiently.” What is noteworthy, however, is its explanation for this deficiency; it attributes the failure not to the capacity of corrupt networks to prevent investigations but rather to the lack of sufficient legislation.²⁷⁵

Others believe that the scarcity of high-profile cases stems from the fact that there is relatively little high-level corruption in the first place; Tanel Kalmet, an anti-corruption specialist at the Justice Ministry, believes “there is not much evidence of corruption going on at the top levels.” To the extent that there is a failure to prosecute such cases, the primary reason is not the complicity of law-enforcers in the schemes but rather the lack of adequate resources and training available to investigators (in surveillance, for example). These are not sufficient when considered in light of the sophistication of the criminals. For the same reason, enforcement of the Political Parties Act is also regarded to be inadequate.²⁷⁶

Until relatively recently, there was a shortage of police investigators dedicated to enforcement in particular legal areas, including but not limited to anti-corruption law. This is the view of Heili Sepp, a Justice Ministry official and former state prosecutor.²⁷⁷ The lack of specialized personnel is especially problematic when it comes to stemming municipal corruption. “Only 21 people work in the Anti-Corruption Bureau, but there are around 230 local municipalities” Anvelt laments.²⁷⁸ “We have 215 local governments,” notes Mati Omblar, head of the Anti-Corruption Bureau. “This creates lots of possibilities for dishonest people to take power in some local municipality and line their pockets with municipal assets.” However, “compared to other ex-Soviet countries, especially in the southern regions, I think we are in a better position.” In fact, Omblar heard similar complaints from American law-enforcement officials on a recent trip to the United States. “We saw the same problems there that we are dealing with in Estonia, like people trying to line their pockets while serving in local government and other agencies.”

²⁷³ Interview with Arnold Sinisalu.

²⁷⁴ Interview with Mari-Liis Sööt, 5 September 2008.

²⁷⁵ Transparency International-Estonia, *Corruption Crimes Handled in Estonian Courts in Years 2002-2008* (Tallinn: Transparency International-Estonia, 2008), 9. Available at http://transparency.ee/cm/files/corruption_crimes_handled_in_estonian_courts_2002-2008.pdf.

²⁷⁶ Interview with Tanel Kalmet, 10 September 2008.

²⁷⁷ Interview with Heili Sepp, 17 September 2008.

²⁷⁸ Interview with Andres Anvelt, 28 February 2014.

Thus far, criminal cases against high-level local officials have been opened in approximately ten municipalities and “the number is rising.”²⁷⁹

Certain institutional domains, such as anti-monopoly and corporate law, were frequently seen as weak when I visited Estonia in 2008. “They have been active in a number of cases,” says Peeter Lepik, referring to the Estonian Competition Authority, the main anti-monopoly body. “But there have not been, shall we say, lots of ‘dawn raids’.” While they have certainly pursued cases, the country’s anti-monopoly enforcers have not been as vigorous as their West European counterparts. “We’ve been told by our West European clients that, whenever your competitor starts talking to you about prices, you must leave the room. That’s not exactly the case here.” Again, however, the problem is not that the relevant authorities are corrupt but rather that they lack sufficient enforcement capacity.²⁸⁰

The civil courts continue to be plagued by delays that can impede efforts by minority shareholders to defend their rights. “The court cases can take so long that, often times, you’ll find the train has already left the station, and a positive ruling makes no difference,” Lepik explains. At the same time, he adds, Estonia is no different in this regard from any West European country. “You can’t get a quick decision there either.”²⁸¹ However, Anton Sigal notes, “when there is evidence of criminal misconduct, the system can operate very quickly and efficiently.” One case he worked on involved a majority owner who attempted to tunnel real estate out of a company he jointly held with a minority shareholder. The real estate was transferred to multiple entities spread out among six or seven different counties. Because each county had its own land registry, blocking the illegal transfers required that separate motions be filed in each jurisdiction. Nevertheless, upon the discovery of the scheme, Sigal’s law firm managed work with judges to stop 90 percent of the transfers in the span of two days.²⁸²

Another problem my respondents attribute to limited enforcement capabilities is the practice by politicians of setting up “consulting firms,” known for submitting bills to private companies for “consultation services.” “It’s pure extortion,” one respondent complains, and it only works because of the difficulties prosecutors face in detecting it.²⁸³

Indeed, most of the corruption in Estonia takes place in the sphere of party politics rather than the state administration itself. Corruption in party financing was present from the very start. At times, campaign donations could be used to extract soft budget constraints. For instance, a 1997 decision by the Pro Patria government to impose favorable excise taxes on beer was widely suspected to be a favor to influential party supporters.²⁸⁴ “Until 1999, the financing of political parties was, as one of the main experts on the country’s party finances puts it, ‘a complete mess,’” states a report by the Open Society Foundation. Party financing was mostly unregulated and marked by unrestrained donations from companies. A 1999 World Bank survey placed Estonia among the worst post-communist offenders in the percentage of businesses reporting party contributions to be a burden. Parties widely disguised illicit donations as legitimate

²⁷⁹ Interview with Mati Ombler, 7 March 2014.

²⁸⁰ Interview with Peeter Lepik, 3 November 2008.

²⁸¹ Ibid.

²⁸² Interview with Anton Sigal, 6 October 2008.

²⁸³ Interview with Respondent #105.

²⁸⁴ Open Society Institute, *Corruption and Anti-Corruption Policy in Estonia* (New York: Open Society Institute, 2002), 223-27.

contributions from party members. Only in that year did a new law forbid anonymous donations, ban contributions from state agencies, limit the size of cash donations, and require parties to publish their financing sources. Nevertheless, the law did not explicitly provide for the supervision of political party accounts and failed to specify criminal sanctions for violating the rules.²⁸⁵ Further improvements to the law came in 2004, when donations to parties from corporations and organizations were banned (although permitted in the case of individual candidates). However, allegations persisted that political parties continued to milk state companies for financing.²⁸⁶

The main problem is no longer the law itself but rather its enforcement. For instance, while all legal donations along with their sources are officially reported and publicly available, there is no government body responsible for inspecting them. Illegal donations, of course, are not reported at all; a common complaint points to “shadow sponsors” who maintain anonymity by channeling donations through more reputable businesspeople.²⁸⁷ Meanwhile, oversight of party financing rests in the hands not of an official state agency but rather a parliamentary select committee that is controlled by the parties themselves. Accordingly, periodic scandals have arisen over the corrupt financing of political parties. Some of the most notable cases involved donations from companies that participated in the initial (aborted) Estonian Railways privatization, alleged favoritism by the Center Party to chocolate magnate Oliver Kruuda, and links between the Res Publica party and two wealthy businessmen, Olari Taal and Tõnis Palts. The biggest scandal exploded in 2012 when a former MP publicly admitted to having funneled anonymous campaign donations to one of the main political parties, leading to the resignation of the Justice Minister. Nevertheless, “[s]candals related to party financing have been modest compared to most Central and East European countries” conclude Allan Sikk and Riho Kangur. “Despite problems in party financing,” they add, “none of the parties could reasonably be considered to be ‘pocket parties’” of certain business groups.²⁸⁸

Even if there are problems in the effective enforcement of certain rules, what is most relevant for the purpose of this investigation is that the rules are hardly ever used to attack one’s business rivals. This differentiates Estonia from Poland, Slovakia, and Ukraine. A comment from journalist Enno Tammer on the land-exchange scandal underscores this fact. While some suspected that the prosecution of the Environment Minister was really an attack on plutocrat Toomas Annus, Tammer doubted such claims. When asked why, he replied: “Because the Security Police is behind the investigation, and nobody can influence the Security Police to attack a rival.”²⁸⁹

²⁸⁵ Ibid., 220-23; quotation comes from 220-21.

²⁸⁶ Interview with Respondent #105.

²⁸⁷ Interview with Sulev Vedler, 18 September 2008.

²⁸⁸ Allan Sikk and Riho Kangur, “Estonia: The Increasing Costs and Weak Oversight of Party Finance,” in *Public Finance and Post-Communist Party Development*, ed. Steven D. Roper and Janis Iktens (Aldershot, UK and Burlington, VT: Ashgate, 2008), quotations appear on 74-75. PDF available at <http://eprints.ucl.ac.uk/18586/1/18586.pdf>. Also see European Commission, “Estonia: Annex to the Eu Anti-Corruption Report,” in *Eu Anti-Corruption Report: Report from the Commission to the Council and the European Parliament*, ed. European Commission (Brussels: European Commission, 2014). Available at http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/corruption/anti-corruption-report/docs/2014_acr_estonia_chapter_en.pdf.

²⁸⁹ Interview with Enno Tammer, 5 November 2008.

Alternative Explanations for Estonian Exceptionalism

Observers both within and beyond the country have put forward a number of explanations to account for Estonian exceptionalism. This section will briefly consider these.

One that can be dismissed out of hand is the absence of a powerful communist successor party. It might potentially account for why Estonia has not suffered the same level of corruption, economic fraud, and criminal corporate raiding seen elsewhere in the region. At first glance, the argument seems logical; we have already observed how much of Poland's economic criminality was perpetrated by business elites linked to the social democrats. On the other hand, the Czech Republic also lacked a viable successor to the communist party until the 1998 elections (when the social democrats formed a government for the first time). Yet examples of fraud and asset-stripping there were legion in this period.²⁹⁰ Evidently, corruption and property-rights abuses can flourish in the absence of a strong communist successor party.

Another possibility is the large amount of foreign direct investment that came to Estonia from the West. Western capital, after all, may have brought Western practices along with it. Some Estonians certainly think so. When the government relaxed restrictions on foreign ownership in 1991, "this led to a boom in the founding of foreign-owned companies," according to Peeter Lepik. "The big ones came to Estonia with their business ethics and a new way of doing things."²⁹¹

However, many of my Ukrainian, Polish, and Slovak respondents scoffed at such notions, at least when applied to their own countries; they complained bitterly about the advantages rich Western firms enjoy over their poorer local counterparts thanks to their superior war-chests, which can easily be deployed to bribe officials. A Ukrainian businessman in the agricultural sector lambasts the hypocritical anti-corruption moralizing of Western countries whose firms freely partake in bribery whenever it suits them. While the biggest multinational companies do not pay bribes, medium-sized ones certainly do, he says. These firms can import banned or restricted products into Ukraine, offering bribes at the border to get around any inconvenient regulations. For instance, genetically-modified organisms (GMOs) are illegal in Ukraine. "But do you know that 70% of the soybeans produced in Ukraine are GMO?" he asks incredulously. "And then you have to wonder where they come from:"

...I'm not against GMO; I'm against the corrupt ways of doing these things. Because if you want to call me the guy who doesn't follow the law, I mean, let's play fair here. Don't bring me this stuff. Follow the rules that are here for everyone else. Why do I have to follow the rules because I'm poor, and why do you have the right to come through the border, pay somebody, come into this country, and do whatever you want? That's not fair to me, as a local Ukrainian. Because I don't have the money to pay the bribes...So America is very good at calling Ukraine a very corrupt country, but they help very much in doing this. They do it themselves...So Ukraine is a place where you can bring all the junk you want without following the rules. Because you know there are guys at the

²⁹⁰ See, for example, Schwartz; Gould.

²⁹¹ Interview with Peeter Lepik, 3 November 2008.

border in Ukraine and you give them \$500 here, \$1000 there, and they will let anything – atomic bombs – into the country.²⁹²

Jacek, the Polish businessman we met in a previous chapter, likewise condemns the corrupt practices of Western companies in his province, accusing them of bribing authorities to get away with VAT fraud. “For example, we’ve got big French investors here. So they come to Poland and what they do is engage in this transfer-pricing scheme. The Tax Office is not going to fight them, but it’s going to squeeze us to make up for the lost tax revenue. And the tax office doesn’t attack them because they’ve got good lawyers, good political relationships, they’ve got this and that, and it’s very difficult to fight them. But to fight with smaller Polish firms is very easy.”²⁹³

Most of the complaints I received, like that of my Ukrainian respondent, related to modestly-sized Western firms, not huge multinationals. But many of the latter can hardly be considered model corporate citizens. Germany’s Siemens is especially infamous, with one German investigator going so far as to say that “bribery was Siemens’ business model.” In 2008, the company agreed to pay a record \$1.6 billion to American and European authorities to settle allegations of corruption in foreign countries.²⁹⁴ BAE Systems likewise spread bribes around a large chunk of the Czech political establishment (among many others) in order to win approval from a skeptical parliament on a no-bid contract.²⁹⁵ Whether the impact of Western FDI on property rights is positive or negative on balance remains uncertain. At best, the jury is still out.

Others note the possible role of the country’s restrictive citizenship policies which effectively exclude most Russian-speakers from voting. Being that this is “a group higher on collectivism and lower on support [for] a market economy than the Estonian population, according to surveys,” this could have facilitated the entrenchment of sound property-rights institutions.²⁹⁶ But the political exclusion of Russian-speakers apparently did little to prevent the explosive levels of corruption and cronyism in neighboring Latvia. Even if it did play a role, restricting the supposedly less market-friendly Russian-speakers from the vote would have only affected the ease with which Estonian governments could implement hard budget constraints; it could not have been expected to exert any independent impact on the integrity of market-supporting institutions.

Another possible explanation is Estonia’s tiny size. With a population of 1.3 million, it is virtually a city-state. Smallness may certainly have brought advantages. For one thing, the vulnerability of Estonia in relation to its powerful neighbor to the east may have been enough to concentrate the minds of its early reformers; “economic policy was simultaneously seen as an integral part of the state- and nation-building process, and as a means to disentangle the Baltic societies from the dual hegemony of a centralized

²⁹² Interview with Respondent #57

²⁹³ Interview with Jacek.

²⁹⁴ Bruce Watson, “Siemens and the battle against bribery and corruption,” *The Guardian*, 18 September 2013 (<http://www.theguardian.com/sustainable-business/siemens-solmssen-bribery-corruption>); Siri Schubert and T. Christian Miller, “At Siemens, Bribery Was Just a Line Item,” *The New York Times*, 20 December 2008 (<http://www.nytimes.com/2008/12/21/business/worldbusiness/21siemens.html?pagewanted=all&r=0>).

²⁹⁵ Andrew Feinstein, *The Shadow World: Inside the Global Arms Trade* (New York: Picador, 2011), 199-217.

²⁹⁶ Kasemets, 31.

Moscow government and the Soviet economic system,” according to Nørgaard and Johannsen.²⁹⁷ To the extent that it did have an impact, however, it was only by influencing the decision to implement hard budget constraints.

That said, smallness could have exerted other effects independently of its role in determining policies on budget constraints. For example, the absence of a large and unruly state administration may have facilitated efforts by Estonian reformers to enforce legal property rights; in 1990, the Polish state had over eight times as many employees as that of Estonia.²⁹⁸ Nevertheless, being small carries significant disadvantages as well. Two prosecutors I interviewed complained that the high mutual familiarity among the population limits people’s willingness to testify against others since it might render them exposed. It also ensures that many individuals who are interrogated have some kind of an interest in the case under investigation. This, they argue, is why high-level prosecutions are relatively rare.²⁹⁹ Whether smallness helps or hinders the effectiveness of property-rights institutions is thus a question that remains open.

An additional hypothesis of particular importance is the possibility that Estonia has a tradition of relatively professional and non-corrupt governance, at least when compared to many other post-communist countries.³⁰⁰ This legacy, to the extent that it exists at all, could stem from the close cultural connection to Finland, enjoys a strong anti-corruption reputation.³⁰¹ Alternatively, it might be attributed to the country’s long Protestant tradition, a key component of Estonian nationalism.³⁰² Writing in 1993, Anatol Lieven, perhaps the most astute Western observer of the Baltic states at the time, noted that “I have often criticized Baltic nationalism, but in the post-Communist world it is of irreplaceable importance in providing some sort of hedge against blatant corruption, and in mobilising a sense of service and sacrifice. It is especially true of Estonians, with their puritanical traditions...it is certain that the members of the Estonian Right-wing government which took power in October 1992 are people as honest and dedicated as one would find anywhere in European politics; and their honesty is intimately connected with their Estonian nationalism.”³⁰³

Most respondents who served in official positions under communism noted that bribery and gift-giving were rare. “Even during Soviet times, it wasn’t easy at all to bribe a judge,” according to Helve Särgava, herself a judge in the communist period. “Estonia cannot be compared to Georgia at all on this question. In Georgia, anything can be bought...At the time I was serving as a judge, I never heard of it happening.”³⁰⁴

However, not all are in agreement on this point. Alar Kirs, a prosecutor and investigator who worked under the old regime, agrees that giving bribes was not a common occurrence. “However, attempts to do so were more frequent,” he adds. Other specialists take a more unqualified view. Randma goes so far as to call the communist-

²⁹⁷ Nørgaard and Johannsen, 108-09.

²⁹⁸ Grzymała-Busse, 134 (Table 4.1).

²⁹⁹ Interview with Kadri Valing and Kristel Siitam-Nyiri, 15 September 2008.

³⁰⁰ Kasemets, 32-33.

³⁰¹ *Ibid.*, 32.

³⁰² *Ibid.*, 31.

³⁰³ Lieven, 318.

³⁰⁴ Interview with Helve Särgava, 6 November 2008.

era civil service “a clear example of a patronage system with no regard to merit principles.”³⁰⁵

Indeed, low corruption tends to be an attribute of independent states rather than colonies. But for most of its history, Estonia has been ruled by a succession of outside powers from Sweden and the Polish-Lithuanian Commonwealth to the Russian and Soviet empires. Colonial outposts are not generally renowned for their bureaucratic rectitude (think of India, Africa, and Latin America). If this reasoning is correct, one would expect Poland, with its long tradition of independent rule, to exhibit less corruption than Estonia, but that is clearly not the case.³⁰⁶

Thus, whether or not Estonia brought into the post-independence period a legacy of non-corrupt statehood is hard to pin down. But for the sake of argument, let us assume that it did. Could this legacy have accounted for the lower frequency of raiding and the greater robustness of property rights institutions? It certainly could have. To the extent that it played a role at all, however, it likely did so by first influencing the propensity of Estonia’s early post-communist governments to impose hard budget constraints. A tradition of corrupt, patrimonial rule would have made its leaders more amenable to doling out subsidies, soft loans, and tax breaks to their cronies. The absence of such a legacy would have reduced their propensity to do so.

Nevertheless, a legacy of bureaucratic rule need not have acted solely by influencing the likelihood of hard budget constraints; a lower tendency for official bribe-taking could have simply rendered raiding more difficult to execute and property rights institutions likelier to develop.

This possibility - that a bureaucratic tradition influenced the dependent variables independently of hard budget constraints - must be given serious consideration. But while it might explain why Estonia has less raiding and stronger property rights institutions, it cannot account for the lesser prevalence there of political thugs and crony capitalists - at least not on its own. To generate wealth, such actors commonly rely on only two sources: criminal corporate raiding and soft budget constraints. Raiding, as we have seen, tends to be practiced only by political thugs, not crony capitalists. And even for the political thugs who do engage in it - and not all do - it is very rarely their only route to wealth. In fact, none of the political thugs in this study have used raiding as their exclusive - or even primary - method of making money. Soft budget constraints are absolutely critical to political thugs and quite often to crony capitalists as well. They must accordingly be given pride of place in accounting for their rise to prominence.

Bribing state officials is often necessary for accessing both raiding and soft budget constraints. A legacy of non-corrupt, bureaucratic statehood would have made bribery - and, thus, raiding - more difficult for political thugs to pull off. But because economic criminals necessarily make extensive use of soft budget constraints as well, bribery - and its causal determinant we are proposing here, a tradition of bureaucratic statehood - must have exerted its effects at least in part by first influencing the likelihood of soft budget constraints. The legacy of non-corrupt rule in Estonia - to the extent that it existed at all - could not have played an entirely independent role in preventing the rise to prominence of political thugs and crony capitalists; to some extent, it had to operate by

³⁰⁵ Randma, "A Small Civil Service in Transition: The Case of Estonia," 42.

³⁰⁶ I thank Steve Fish for this observation.

first reducing the possibility of soft budgets. This is why Estonia's bureaucratic tradition could not have been sufficient on its own to drive the outcomes under consideration.

Whether or not this historical legacy helped make hard budget constraints more likely is beyond the scope of this study. What is clear is that, with or without such a tradition, hard budget constraints necessarily played an important role in ensuring that the Estonian business elite would contain relatively few political thugs and crony capitalists. And the fact that it contained so few of them is most certainly of paramount importance in explaining why the country has so little raiding and such effective property rights institutions.

Regardless of how clean Estonian governance was before independence, had soft budget constraints remained in place into the mid-1990s they would have kept alive a budding class of political thugs and crony capitalists. Soft budgets would have enriched and empowered these economic parasites who could in turn have used their wealth and influence to corrupt legions of politicians, bureaucrats, judges, and police - whose relatively meager pay at the time rendered them particularly susceptible to such overtures. In a context of severe economic crisis made temporarily worse by radical market reforms, economic predators might also have exploited the declining popularity of Laar's Pro Patria government by financing the opposition. Likewise, they could have held the prospect of golden parachutes over the heads of government officials set to lose power in the next elections. Fortunately for Estonia, this outcome was averted by the sweeping and rapid pursuit of hard budget constraints, which severely stifled the emergence of political thugs and crony capitalists.

Conclusion

By draining the criminal swamps, hard budget constraints create an environment in which the construction of effective property rights institutions can proceed. The case of Estonia shows just how possible this is; starting out with an unusually meager institutional endowment, successive Estonian governments not only built an impressive set of property rights institutions but have been able to continually improve them over time. They achieved this only because hard budget constraints tilted the business and political environments against the kinds of economic predators that proved so disruptive in Poland, Slovakia, and Ukraine.

We now turn to the concluding chapter of this investigation. It will break down the specific measures that must be taken to irreversibly marginalize the political thugs and crony capitalists who so often act as a break on institutional development. As we will see, these efforts must begin in Washington and Westminster.

Well, I don't really think that the end can be assessed as of itself as being the end, because what does the end feel like? It's like saying, when you try to extrapolate the end of the universe, you say, if the universe is indeed infinite, then how – what does that mean? How far is all the way, and then if it stops, what's stopping it, and what's behind what's stopping it? So, what's the end, you know, is my question to you.

—David St. Hubbins, when asked by a reporter if the career of Spinal Tap, his hair-metal rock band, has come to an end¹

Conclusion

What Is To Be Done?

When and how can a new reformist government irreversibly weaken the economic criminals acting as a brake on the development of property rights institutions? When and how can the criminals preserve their institution-sapping influence? This is the central question of this study. The findings show that political thugs and crony capitalists will eventually die off if deprived for long enough of the soft budget constraints on which they depend. This, in turn, will create a favorable environment for the construction and continual enhancement of market-supporting institutions. In the absence of hard budget constraints, efforts to build institutions will likely falter under the weight of predatory interests with a stake in undermining them. Conversely, an environment in which business actors must rely on their own capital to survive can decisively shift the balance in favor of entrepreneurs, the only ones who can prosper in such conditions.

To be sure, the experiences of four post-communist countries hardly provide conclusive proof of this argument; specialists must devote far more attention to the problem before we can arrive at a definite answer. However, if Estonia, Poland, Slovakia, and Ukraine are any guide, the primary focus of our policy prescriptions for building property rights institutions should be hard budget constraints – not privatization, not deregulation, and not market reform writ-large. These other agendas only serve to distract from the fundamental task, which is to weaken the economic predators who obstruct the emergence of functional property rights at every turn. And the frequently-heard calls to “build institutions” will likely prove fruitless without first combating the power bases of these predators.

As this study draws to a close, we will first review the implications of its main findings for social science theory. We will then turn to the specific measures that must be taken to erode the influence of political thugs and crony capitalists. Yes, hard budget

¹ Murphy, Karen, Christopher Guest, Michael McKean, Harry Shearer, and Rob Reiner. 1984. *This Is Spinal Tap*. Santa Monica, CA: Metro Goldwyn Mayer Home Entertainment.

constraints are key. But another critical step is the elimination of the secrecy jurisdictions these actors use to stash their wealth abroad while maintaining a level of invulnerability at home.

Theoretical Implications

The evidence unearthed in the preceding chapters undermines popular perceptions of who the “leaders” and “laggards” are among the post-communist countries. For nearly two decades, most observers have regarded a handful of countries – particularly Poland, Hungary, the Czech Republic, Slovakia, Slovenia, and the Baltic States – as standing above the rest. When considering the progress of democratic and economic reform as a whole, there is something to be said for this view. But it obscures enormous variations in the realm of economic criminality, property rights abuses, and institutional capacity. On this last score, especially, scholars are coming to recognize that the reality is messier than previously thought. In this respect, certain “leaders” appear to be doing better while others differ little from the “laggards.”²

Poland, in particular, is widely considered a star performer in terms of the strength of its legal framework and institutions. The findings of this study effectively falsify such assertions. The evidence presented here is sufficient to put to rest any notions of Poland’s supposedly superior market-supporting institutions. What, if any, differences it displays from countries further east are inconsequential for the security of property rights.

In addition to upending perceptions of who the leaders and laggards are, another notable finding is that long-term economic growth is not impossible under conditions of pervasive property rights violations. In the coming years, students of China and India may indeed start to show that the post-communist countries are not outliers in this regard. But this remains to be seen. At the very least, it is time to start critically examining what has become an unquestioned assumption: that effective property rights institutions are a precondition of economic development. That said, even if we eventually do find that systemic property rights abuses have fewer *economic* consequences than previously thought, they certainly carry profound *moral* implications; those who own and operate property by legitimate means should not have to worry about having their businesses expropriated and lives destroyed at the hands of economic predators. For this reason alone, the question of what causes property rights institutions to arise will remain an essential avenue of inquiry for social scientists.

This study also makes a case for broadening our prevailing conception of hard and soft budget constraints. Until now, those analyzing the issue have tended to look only at loss-making firms. The findings presented here show that chronic loss-makers are far from the only beneficiaries of state largesse; scores of profitable firms too use their political connections to extract soft budget constraints from banks, state enterprises, and the state administration itself. In fact, the soft budget constraints they receive are often the only reason for their profitability in the first place. Furthermore, soft budget constraints arguably produce the same consequences for profitable companies that they

² See, for instance, Grzymała-Busse.

do for loss-makers. They allow inefficient enterprises to survive,³ encourage the pursuit of political favor over innovation and efficiency,⁴ create an excessive demand for credit,⁵ and worsen the fiscal position of the state.⁶ There thus seems little reason to continue viewing only loss-making firms as candidates for soft-budget constraints.

A final reason for expanding the concept is that subsidies, soft credits, and artificial pricing arrangements help sustain a class of economic criminals – regardless of whether they are directed to profitable or loss-making firms. Political thugs and crony capitalists use soft budget constraints to enrich themselves both directly (by receiving subsidies and loans from the state) and indirectly (by tunneling the loss-making enterprises that serve as temporary way stations for subsidies and soft loans). Once we stretch the notion of soft budget constraints, we also come to see how they can take other forms besides those that specialists typically consider. Most prominent among these are underpriced privatizations and overpriced public-procurement contracts. So long as external economic assistance can be obtained without regard to one's capital or revenue position, there exists a soft budget constraint.

This study also suggests there is a sore need for better cross-national quantitative indicators of corruption and property rights protections. As we saw in Chapter One, the mainstream indices rate the four countries in ways that are completely at odds with reality. Anyone who examines Transparency International's *Corruption Perceptions Index* or the World Bank's *Worldwide Governance Indicators* would be forgiven for thinking that Estonia, Poland, and Slovakia are all in great shape while Ukraine is the lowly outlier. The massive amount of case study evidence from preceding chapters gives the lie to such notions; it is Estonia, not Ukraine, that is the real outlier. The deviations between the international indices and the empirical findings here likely stem from the sources on which the indices are based. Those that rely on surveys of businesses are subject to the survivorship bias (you cannot survey a dead business). Those that depend on assessments by civil-society experts fall victim to what might be called the "unfamiliarity" bias; many NGO specialists, academics, and journalists with whom I spoke were largely unaware of the horrendous criminality occurring in their midst. A relative handful of specialists disagreed with this assessment. I privileged testimony from the latter as they were able to provide me with dozens of concrete cases that actually took place. Had I instead taken the "average" response of all my sources as indicative of the true state of affairs – something all of the above indicators necessarily do – the conclusions I drew would have been quite different and far less accurate.

³ Kornai, *The Socialist System: The Political Economy of Communism*; Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries."; Claessens and R. Kyle Peters Jr., "State Enterprise Performance and Soft Budget Constraints: The Case of Bulgaria."; Schaffer, "Do Firms in Transition Have Soft Budget Constraints? A Reconsideration of Concepts and Evidence." Frydman et al. agree that hard budget constraints weed out inefficient firms but only if accompanied by privatization. See Frydman et al., "The Limits of Discipline. Ownership and Hard Budget Constraints in the Transition Economies."

⁴ Kornai, "Resource-Constrained Versus Demand-Constrained Systems."; Kornai et al., "Understanding the Soft Budget Constraint."

⁵ Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries," 1594; Claessens and R. Kyle Peters Jr., "State Enterprise Performance and Soft Budget Constraints: The Case of Bulgaria."

⁶ Kornai, "Hardening of the Budget Constraint: The Experience of the Post-Socialist Countries."; Claessens and R. Kyle Peters Jr., "State Enterprise Performance and Soft Budget Constraints: The Case of Bulgaria."

Given the problems inherent in these sources, is there anyone who can provide a more accurate picture of corruption and property-rights violations among the agents of force? Yes, there is: the agents of force themselves. Surveys of state officials are not subject to either the survivorship or unfamiliarity biases. Yet few if any measures make use of this population. They need to.

This study also yields important implications for the study of why certain countries have more effective market-supporting institutions than others. It challenges the Lamarckian view that improvements in institutional “traits” arise seamlessly once leaders have made the choice to bring them about. This view predominates not only among much-maligned “voluntarist” approaches such as the New Institutional Economics. It applies equally to those who see structural changes behind rulers’ decisions to build institutions; once the choice is made, the assumption goes, the institution seamlessly arises.

In contrast to the Lamarckians, the Darwinian approach advanced here argues that institutional improvements cannot be willed into existence. They first require the marginalization of certain “species” – namely, political thugs and crony capitalists – whose interests are fundamentally opposed to the establishment of authoritative legal rules. And the way to weaken such opponents is to take away the soft budget constraints they rely on for sustenance. Time and again, we have seen how powerful networks of economic criminals in Poland, Slovakia, and Ukraine manipulate and sabotage even modest institution-building efforts. Only in Estonia, where hard budget constraints sidelined budding criminal networks to a far greater extent, did attempts to install effective property rights institution succeed.

The Darwinian approach to explaining the rise of property rights institutions places front and center the role competition. It has done so here in two respects. First, it stressed the importance of competition among business actors as brought about by hard budget constraints. Second, it has shown how robust party competition set the stage for one particular type of hard budget constraint: the privatization of state enterprises through honest means (or at least in the absence of blatant fraud).

Finally, this dissertation highlights the usefulness of examining how actors of differing types – whether governments or businesspeople – affect institutions. Much of contemporary social science, including but not limited to the study of institutional origins, takes the opposite approach, looking at the ways in which institutions influence actors. Historical institutionalism shows how institutions drive differences in the relative power of various groups. Rational-choice institutionalism points to the role of institutions in creating the incentives actors face. Sociological institutionalism holds that institutions shape the very values, attitudes, and identities that actors adopt.⁷ These various modes of inquiry have proven valuable in the past and will surely continue to do so in the future.

However, when studying why and when authoritative property rights institutions arise, we gain considerable leverage by examining how actors shape institutions and not just looking at things the other way around. This investigation has done both. On the one hand, it examined a particular set of policies and institutions – hard and soft budget constraints – and analyzed how these can place actors of varying types into positions of

⁷ Peter A. Hall and Rosemary C. R. Taylor, "Political Science and the Three New Institutionalisms," *Political Studies* 44, no. 5 (1996).

prominence in the business and political worlds. On the other, it has gone beyond the traditional tendency in contemporary social science by addressing the causal role of *actors* in several fundamental ways. First, status-quo actors – political thugs and crony capitalists – must be marginalized for institution-building efforts to succeed. Second, to achieve this goal, actors in the form of new governments must harden budget constraints. Third, we have seen how ex-communist actors in some countries helped foster robust party competition by building strong social-democratic parties; vigorous competition, in turn, kept fraudulent privatizations – a key soft budget constraint – in check. Fourth, with powerful networks of economic criminals out of the way, Estonian leaders took the initiative to construct sound property rights institutions.

Skeptics might contest the notion that actors rather than institutions merit the status of causes at all. Even if political actors in Estonia played a key role in putting hard budget constraints into place, is it not possible that certain institutional forces helped account for their rise to power in the first place? Of course it is. Likewise, if the relative presence or absence of networks of economic criminals determined whether strong property rights institutions could arise, the extent to which such networks took root in turn depended on institutional factors, as we have seen. This points to the problem of infinite causal regression so eloquently captured by Spinal Tap's David St. Hubbins at the start of the chapter; behind the particular causes we identify will always reside deeper, underlying causes.⁸ But regardless of what forces shape the actors in the first place, it remains essential to critically examine how they affect institutions. If we do not analyze the ways actors forge, mold, manipulate, and subvert institutions, our understanding of how and why property rights institutions evolve will not get very far.

Nor will efforts to solve the problem. Telling reformers to simply “build the institutions” without any insight into how to lay the groundwork for this outcome is not particularly useful advice. Let us become more helpful to them by digging up old cases and searching for actual policies that made a difference. Returning to a focus on the various ways actors shape institutions can aid this effort. It is this latter question – of what is to be done – that we turn to next.

Policy Implications

The debate between Lamarck and Darwin not only helps illuminate the two contrasting approaches to institutional origination. It is similarly analogous to the differing policy prescriptions they propose for reform-minded governments in early-capitalist societies. The standard advice, whether it favors implementing certain policies or “building institutions,” tends to assume that governments can put their countries on a course toward economic and institutional development by force of will alone. It is analogous to encouraging giraffes to grow longer necks by making a concerted effort to reach the trees. The conventional approach tends to ignore the need to drive out the status-quo forces who act as a break on meaningful change. If the conclusions of the preceding chapters are correct, the construction of effective property rights institutions requires the extinction or marginalization of the economic criminals with an interest in keeping them weak.

⁸ For a more scientific perspective on how precisely to deal with the problem of infinite causal regression, see Slater and Simmons, "Informative Regress: Critical Antecedents in Comparative Politics."

The findings of this study offer an enormous lesson for would-be reformers all over the world, from Indonesia to Kenya, at this very moment. If its conclusions are correct, efforts to build market-supporting institutions without first undermining predatory business elites will likely fail. It is comparable to sticking one's fingers in a dike riddled with holes; the gushing water will react by finding other holes through which to flow. Consider the adoption of better protections for minority shareholders, a measure frequently proposed by institutionalists to prevent abuses in the sphere of corporate governance. Ukraine has enacted stringent guarantees on the rights of minority shareholders. But far from improving the situation, they only serve to grant powerful political thugs enormous leverage to buy up small shareholdings in target firms as a prelude to expropriating them from majority owners. In fact, behind the adoption of such rules can be seen the influence of the very political thugs who subsequently exploit them for illegal ends. When the economic and political spheres are under the thumb of economic predators, calls to "build institutions" will likely fall on deaf ears while efforts to put them in place will fail under the weight of criminal manipulations.

To take another example, recently-compiled rankings on the transparency of rules governing corporate information place such obviously criminalized economies as Albania, Bosnia-Herzegovina, Kyrgyzstan, and Russia above the United States.⁹ This goes to show just how meaningless sound rules can be in environments where political thugs and crony capitalists reign supreme.

Rather than trying to establish all manner of market-supporting institutions, reformist governments in early-capitalist countries may get more bang for their buck by adopting measures to weaken predatory business actors – specifically, by imposing hard budget constraints. The successful implementation of hard budget constraints does require putting certain institutions into place, such as a solid framework for banking supervision. But these institutions are limited in scope and specifically target the resource base of political thugs and crony capitalists, thus weakening their ability to obstruct the adoption of additional market-supporting institutions. Moreover, because it involves a more limited range of institutions, the adoption of hard budget constraints eases the burden on governments in early capitalist contexts who typically find themselves hamstrung by a shortage of resources and trained personnel.

In fact, a focus on hard budget constraints sidesteps the interminable debate among social scientists over whether liberal market policies are sufficient for economic development or if institutions are required as well. Hard budget constraints involve the adoption of both policies *and* institutions. But they do not encompass all of the policies and institutions advocated by opposing sides in the debate. Neoliberals, for their part, focus on policies: price liberalization, monetary and fiscal stabilization, privatization, and deregulation. Others prioritize separate policies such as debt-reduction. Their opponents demand a host of new institutions from a non-corrupt judicial system, capital-market rules, and better transparency to functioning banks, insurance schemes, unions, and employers associations.

Hard budget constraints involve a little of both but not all of each. They consist of certain policies such as liberalized prices and the abolition of subsidies, soft financing, and tax breaks not justified by economic rationality. But to support these policies,

⁹ The 2014 Arachnys Open Data Compass, *Arachnys Information Services Ltd*, ed. Arachnys Compass, <http://compass.arachnys.com/country/pl.html>

specific institutions are necessary, particularly tough banking supervision along with a functioning bankruptcy system.

Hard budget constraints likewise cut across pro- and anti-statist lines. They require the state to get out of the way in certain respects (ending politically-engineered subsidies, for example) and intercede more forcefully in others (through vigorous banking supervision). In an ideal world, they would come along with uniform and well-enforced accounting rules to prevent the tunneling of enterprises.¹⁰ But for governments dealing with limited resources, it is preferable to focus on banking supervision over a corporate accounting framework. Keeping a close eye on a hundred-odd banks is arguably easier than doing the same for tens of thousands of individual enterprises. Meanwhile, the ability to tunnel those enterprises will remain limited so long as banking regulators ensure they are not continually replenished by soft loans.

In sum, when it comes to building property rights institutions, the focus should be on hard budget constraints, not the full range of policies and institutions that distinguish the currently-prevailing approaches.

Imposing hard budgets not only provides more bang for the buck but is far easier to implement than trying to install a complete set of market-supporting institutions. Stiglitz famously attacked the Russian economic reformers under Boris Yeltsin along with their IMF advisers for ignoring the need to build such institutions. He argued that, in the absence of an effective regulatory framework and tax system, privatization created a class of oligarchs able to strip assets with impunity and transfer their illicit wealth out of the country.¹¹ But Stiglitz has the causal arrows reversed. The rise of political thugs from the early 1990s onward is precisely what hampered Russia's institutional development in the first place. Political thugs were ascendant long before the notorious loans-for-shares privatizations that created the so-called oligarchs).

Stiglitz's contention that these institutions had even a remotely feasible chance of taking root under the conditions Russia faced during the Yeltsin era (or even today) is hopelessly romantic. Installing the kind of effective property rights regime advocated by institutionalists involves the adoption of an enormously complex array of rules as well as a broad range of state agencies to enforce those rules. As we have seen time and again, however, these rules are unlikely to be adopted and will probably fail even if adopted so long as the system remains dominated by economic criminals. In such circumstances, efforts to establish the myriad rules and state agencies that go into a comprehensive set of property rights institutions must pass through too many gatekeepers to succeed; each gatekeeper represents an additional point at which status-quo actors can potentially corrupt the process.

Instead, governments in early-capitalist countries can obtain far greater leverage over the problem by imposing hard budget constraints. Unlike trying to install a full set of property rights institutions, hardening budgets can often be accomplished by a handful of committed reformers in control of a few key ministries. Furthermore, hard budgets will weaken those actors who support the status quo and thereby clear the way to create property rights institutions that actually function as intended.

¹⁰ Atanasov et al.

¹¹ Joseph E. Stiglitz, "Who Lost Russia?," in *Globalization and Its Discontents*, ed. Joseph E. Stiglitz (New York: W.W. Norton, 2002).

While further study is required to determine just how far the findings of this investigation travel, there is some reason for confidence in this regard. In criminalized economies around the world, soft budget constraints can be seen at work creating and sustaining classes of powerful political thugs. Everywhere from Mexico and Venezuela to the Philippines to broad swathes Africa and Iran under the Shah, soft subsidies and bank credits, crony-engineered tax breaks, artificial pricing arrangements, rigged tenders, and fraudulent privatizations have constituted the very bases of wealth and power for predatory business actors.¹² The trillions of dollars in bad loans that have built up over the preceding decades in China¹³ do not bode well for the prospects of its property rights institutions. Even in early-modern Europe, soft budget constraints were instrumental in contributing to the dominance of the nobility; the basis of that economy was land, and its owners did not exactly acquire it using capital obtained through dutiful economic accumulation. Rather, land was bestowed upon clients of the ruler and inherited by their successors thereafter.

Another question for future scholars is whether the implementation of hard budget constraints becomes more difficult to achieve as political thugs and crony capitalists grow wealthier and more politically-entrenched. This study highlights only one successful case in which hard budget constraints were successfully imposed and that was Estonia during the early 1990s. While a number of wealthy and influential business actors already existed by that point, they had not been around long enough to grow and solidify their positions before Pro Patria launched its economic reforms. In countries like Poland, Slovakia, and Ukraine today, by contrast, powerful economic criminals are extremely well-rooted and arguably in a much better position to resist government efforts to rein in soft budgets. While different business actors fall in and out of favor as governments change, each new government tends to assume power thanks in large part to financial backing from one set of actors or another. Each thus begins its tenure at a major disadvantage from the standpoint of implementing real reform. This was certainly true in the first years of the transition as well but the networks of influence are far more established today. What is worse, even those business actors who temporarily lose influence at the policymaking level due to a change in government still have cronies representing them in key positions of the state administration from the ministries and regulatory agencies to the police and courts. This can complicate efforts to enforce hard budget constraints and punish those who aid and abet the provision of illegal soft budget constraints. Not only that, many political thugs have by now commandeered control of efficient enterprises, leaving them less dependent on state largesse than they were in the 1990s. Consequently, cutting off the flow of such largesse may not weaken them as much as it once would have – and yet their ability to abuse the property rights of others remains intact. Unfortunately, the evidence from this investigation does not allow a systematic inquiry into the impact of varying degrees of criminal entrenchment on the

¹² On the Philippines, Mexico, Venezuela, Nicaragua, and Iran under the Shah, as well as Brazil, Argentina, and Paraguay under military rule, see Henry; Nicholas Van de Walle, *African Economies and the Politics of Permanent Crisis, 1979-1999* (Cambridge and New York: Cambridge, 2001).

¹³ John Mauldin, “Can Central Planners Revive China’s Economic Miracle?” *Thoughts from the Frontline*, 8 June 2014 (<http://www.mauldineconomics.com/frontlinethoughts/can-central-planners-revive-chinas-economic-miracle>).

prospects and effectiveness of hard budget constraints. This question must be left to future scholars.

Nevertheless, in almost all cases, soft budget constraints continue to play an instrumental role for corrupt business actors and their evolving fortunes. Their power would surely be undermined if governments took away the easy access to state resources they currently enjoy. In Ukraine, tax breaks, state-guaranteed monopolies, and cronyist financing from pocket banks as well as fraudulent public procurement tenders and privatizations remain essential to political thugs and crony capitalists. A similar situation prevails in Poland and Slovakia (though without the pocket banks, as much of their respective banking industries are now under foreign ownership). To be sure, economic criminals in all three countries possess substantial resources to survive a reasonably long winter of hard budget constraints and honest governance. But a reformist administration that not only adopts such measures but lasts in power for multiple terms to boot could very well tilt the balance decisively against them and in favor of entrepreneurs. At this late stage, it may require a prolonged, gradual process to irreversibly marginalize the defenders of the status quo. But nobody ever said it would be easy. In an early-capitalist context, hard budget constraints may very well be the best hope for getting the job done – far more so than romantic fantasies of transplanting German-quality institutions onto post-Soviet Russia.

What is clear is that, for governments seeking to harden budget constraints, speed is of the essence. Stiglitz and other likeminded scholars have consistently argued for gradual over rapid reform. Each country must proceed at its own pace and a gradual approach is usually most appropriate, or so the argument goes.¹⁴ Whether or not gradual reform is optimal for ensuring long-term growth is beyond the scope of this investigation. However, when it comes to laying a foundation for sound property rights, slow-and-steady is probably not the answer.

In defending his case for gradualism, Stiglitz again cites Russia – mistakenly – as a case of radical market reform attempted too quickly.¹⁵ What most critics of Russian reform fail to consider is that, despite the rapid price liberalization and privatization programs, the policies of the Yeltsin-Gaidar team were far from radical in one important respect: the imposition of hard budget constraints. To this day, Russian firms remain propped up by tax breaks, cheap energy supplies from Gazprom, and other privileges (not to mention soft budget constraints in the form of fraudulent public tenders and privatizations).¹⁶ In this regard, Russian reform *was* gradual. For a case of truly radical shock therapy, one need look no further than Estonia. Indeed, if reformist governments are not sufficiently quick to harden budget constraints, they will likely face mounting pressure to give into corrupt status-quo interests as support from their key constituencies begins to wane. The cases of Poland, Slovakia, and Ukraine offer up plenty of examples of initially well-intentioned governments that foundered under the weight of corrupt enticements from political thugs and crony capitalists. If hard budget constraints are to be attempted at all, they must be both comprehensive and swift.

¹⁴ Stiglitz, *Globalization and Its Discontents*, chapters 3 and 5.

¹⁵ *Ibid.*, chapters 1 and 5.

¹⁶ Although it is by now a dated account, see Clifford G. Gaddy and Barry W. Ickes, *Russia's Virtual Economy* (Washington: Brookings Institution, 2002). For a recent report, see Yekaterina Kravtsova, "Navalny Publishes Sochi Corruption Report," *The Moscow Times*, 28 January 2014

As previous chapters have indicated, certain international actors have variously served to enhance or mitigate the tendency toward economic criminality and the development of property rights institutions. Because the four countries were equally exposed to the influence of these actors, their impact to date cannot be considered decisive. But this need not be the case in the future. International organizations such as the European Union, OECD, IMF, World Bank, and others can potentially play an important role. Only until now, the advice they have tended to give developing countries has been all over the board. This reflects the wide range of policies and institutions advocated by specialists as the “right” solutions to the problems besetting these societies. Reformist governments will continue to come to power in early-capitalist countries. They could well achieve greater success than they have in the past if only they receive the right advice. If further studies manage to confirm the conclusions of this investigation, international organizations could aid these reformers by shifting away from recommending myriad institutional reforms from privatization and corporate transparency to cleaning up the judicial system and instead focus on the key component: hard budget constraints.

In addition to hard budget constraints, there is one other set of measures that promises to weaken the influence of political thugs and crony capitalists across the early-capitalist world. Given the consequences for both developing and developed countries, secrecy jurisdictions and tax havens may be the most understudied and underreported issue of our time.¹⁷ To get a handle on the sheer scale of the problem, it is worth quoting at length Nicholas Shaxson. His *Treasure Islands* is perhaps the most important book of the last ten years on economic criminals and their patrons in the global financial and political establishment:

[James] Henry’s calculations suggested that at least half of the money borrowed by the largest debtor countries [from global financial institutions in the 1970s and 1980s] flowed right out again under the table, usually in less than a year, and typically in just weeks. The public debts were matched almost exactly by the stock of private wealth their elites had accumulated in the United States and other havens, and by the early 1990s there was enough flight wealth in Europe and the United States to service the entire debt of the developing world—if only its income were taxed modestly. For some countries, like Mexico, Argentina, and Venezuela, the value of the elites’ offshore illicit wealth was worth several times their external debts. Today the top 1 percent of households in developing countries owns an estimated 70 to 90 percent of all private financial and real estate wealth. The Boston Consulting Group reckoned in 2003 that over half of all the wealth owned by Latin America’s wealthiest citizens lay offshore. In June 2010 Henry reckoned that the total stock of flight capital financial wealth from developing countries in 2007 had reached \$7–8 trillion—more than half under the custody or management of the world’s top 50 banks.

One U.S. Federal Reserve official noted: “The problem is not that these countries don’t have any assets. The problem is, they’re all in Miami.”¹⁸

¹⁷ A few notable exceptions are Shaxson; Baker; Henry; Global Witness, *Undue Diligence: How Banks Do Business with Corrupt Regimes*.

¹⁸ Shaxson, 142-43.

Backing up these numbers is a 2013 report from the international watchdog, Global Financial Integrity. It shows that, from 2002 to 2011 alone, a whopping \$5.9 trillion moved out of the developing world.¹⁹ A recent investigation by the International Consortium of Investigative Journalists (ICIJ) and the Center for Public Integrity (CPI) relied on a leaked cache of 2.5 million documents to reveal the identities of global jetsetters and politicians who make use of the offshore system (complete with a searchable database).²⁰ But even the ICIJ/CPI project – one of the most wide-ranging investigations of offshore to date – barely scratches the surface.

Shaxson shows just how wrong the academic and policy establishments are on the issue of offshore secrecy jurisdictions; “building institutions” cannot work in an early-capitalist context so long as corrupt status-quo actors remain in charge – and are enabled by global havens providing a safe and secure outlet for their wealth. He continues, noting offshore’s role in every financial crisis in the developing world over the past several decades:

Economists have not ignored these issues [of offshore] entirely, but they almost always break them down into discrete, country-level local problems that only blame corrupt local elites. These matter, of course, but such analyses obscure what all the disasters have in common: offshore.

And when offshore erosion has been considered, it has been taken as an inconvenience, to be addressed with Band-Aids. As one IMF report put it: “Offshore banking has most certainly been a factor in the Asian financial crisis. A special effort is therefore needed to help emerging economies...to avert financial crises through dissemination of internationally accepted prudential and supervisory standards.”

The IMF is arguing here in an illogical circle. By helping local elites effectively place themselves above the law and creating new temptations to mischief, the offshore system entirely neuters the chance of prudent regulation and supervision that is needed to protect those countries against that very same offshore system. Imagine if those elites had to keep their money bottled up at home, or at least account for their wealth, pay appropriate taxes on it, and submit to appropriate laws. Very soon they would understand why good government is directly in their interest.

Perhaps the saddest part of all this is that it should have been obvious to anybody who gave it a moment’s thought.²¹

Leaving aside the suggestion that economic criminals, if forced to keep their wealth at home, would suddenly become advocates for good government, preventing them from keeping it offshore would certainly render them weaker and more vulnerable. This, in

¹⁹ Dev Kar and Brian LeBlanc, *Illicit Financial Flows from Developing Countries: 2002-2011* (Washington: Global Financial Integrity, 2013).

²⁰ The International Consortium of Investigative Journalists and The Center for Public Integrity, *Secrecy for Sale: Inside the Global Offshore Money Maze* (Washington: The International Consortium of Investigative Journalists and The Center for Public Integrity, 2013). Available at <http://www.icij.org/offshore>. For the searchable database, go to <http://www.icij.org/offshore/search-offshore-leaks-data>.

²¹ Shaxson, 144.

turn, might give reformist governments the leeway they need to harden budget constraints and put sounder institutions into place. However, as things currently stand, the global offshore system allows political thugs and crony capitalists the world over to remain unaccountable to the states where they reside. They can easily shift their wealth abroad at the earliest sense of danger, as wealthy Russians and Ukrainians could be seen doing as the 2014 crisis began heating up.²²

Make no mistake: “offshore” has nothing to do with islands and everything to do with politically stable jurisdictions where foreigners can evade the rules of their home countries. By this definition, the biggest offshore haven in the world is not some tiny Caribbean outpost. It is rather the “British spiderweb,” Shaxson’s term for the City of London and the myriad British Overseas Territories and Crown Dependencies that funnel cash to it from all corners of the globe. The City of London is not to be confused with the city of London; the City is a one-square-mile medieval relic in central London and a virtual state-within-a state that is largely exempt from UK regulations. Its evolution toward the status of the world’s preeminent secrecy jurisdiction began in the 1950s, replacing Britain’s crumbling political empire with a financial empire of a new sort.²³

The other most important secrecy haven is the United States itself, which began its descent toward this status starting in the late 1970s.²⁴ For example, anybody, no matter how criminal, depraved, or otherwise disreputable – Kim Jong-un, the Islamic State of Iraq and Syria – can safely stash his or her wealth behind a web of trusts and LLCs in Wyoming. The reason is that Wyoming does not require any records containing the names of corporate officers and members, let alone ultimate beneficiaries, to be kept within the state’s boundaries; “YOUR NAME IS ON NOTHING,” boasts one Wyoming website.²⁵

If lax corporate disclosure laws were not enough, the world’s top-fifty banks, which service most the offshore elite, are based disproportionately in the United States and the City of London.²⁶

Shaxson lays out the reforms that are necessary to rein in the offshore system: country-by-country reporting for multinational corporations and especially the large banks; expansive rules for the sharing of information among countries on the assets of their residents; the dismantling of the City of London Corporation and the corresponding British spider web; a tax on land (“whether or not [a] piece of prime real estate is owned by a Russian oligarch hidden behind a Liechtenstein *anstalt*, the bricks of the building sited there are rooted firmly into the soil, and the tax can be levied”);²⁷ taxing multinational firms on the basis of “real things like sales, payrolls, and assets” in a given country, which will end their current practice of shifting the bulk of taxable income to

²² Kate Allen and Vanessa Houlder, “East European oligarchs rush to snap up London property,” *Financial Times*, 27 April 2014 (<http://www.ft.com/intl/cms/s/0/9ddc9944-cbd3-11e3-a934-00144feabdc0.html>).

²³ Shaxson, 87-106.

²⁴ *Ibid.*, 107-28.

²⁵ *Ibid.*, 122.

²⁶ Global Witness, *Undue Diligence: How Banks Do Business with Corrupt Regimes*. Available at <http://www.globalwitness.org/library/undue-diligence-how-banks-do-business-corrupt-regimes>.

²⁷ Quote comes from Shaxson, 225. On the use of UK real estate by wealthy foreigners to shift assets out of their home countries, see Cynthia O’Murchu, “Secrecy surrounding property held offshore raises eyebrows,” *Financial Times*, 5 May 2014 (<http://www.ft.com/intl/cms/s/0/9d3f96c0-d444-11e3-a122-00144feabdc0.html>).

low-tax jurisdictions; and changing erroneous definitions and cultural perceptions of such notions as “corporate responsibility” (should corporations be responsible only to shareholders or also to the societies that give them the infrastructure, political stability, and educated workforces they depend on?), “corruption” (is it really true that only Nigeria is corrupt and not the offshore centers that allow its citizens’ wealth to be illicitly siphoned away?), and “efficiency” (efficient for whom?).²⁸ To these measures we can add public registries showing who the ultimate, flesh-and-blood beneficial owners are of all corporate entities; this would finally enable us to say, “No, Robert Mugabe, you cannot open a bank account in the United States.”²⁹

He also recommends assisting developing countries in the creation of effective tax systems.³⁰ That is a worthy goal but is unlikely to succeed in places where political thugs and crony capitalists are firmly entrenched. This underscores just how important it is to marginalize their power by taking action against the offshore system abroad and subjecting them to hard budget constraints at home.

Finally, the Financial Action Tax Force can be used to combat money laundering, even if is not currently serving this function with even remote adequacy.³¹

Any attempts to put Shaxson’s proposals into practice would surely draw hysterical protests from large financial firms who would threaten, as they have always done in response to such initiatives, to move elsewhere. His recommendation? Let them! Repeated financial crises have shown again and again that huge banks cause at least as much harm as good to the economy. If they choose to leave, then good riddance. Worthy economic projects will always attract financing; there is no reason it has to come from Citigroup.³²

Once again, international actors must play a central role here. These include not only the United States and United Kingdom, who are currently doing so much to maintain the offshore system, but also the European Union, OECD, IMF, and World Bank. The offshore problem is international in scope and accordingly requires international solutions. One of the key measures requiring international coordination is the use of sanctions and blacklists against countries and financial institutions who fail to comply with the new standards mentioned above. As important as they are, the US and UK hardly constitute the whole of the global offshore system. Consequently, any reforms carried out by the American and British governments cannot directly force changes in other offshore havens such as Cyprus, Hong Kong, and Lichtenstein. Blacklists are the answer to this problem. The evidence for this came during a brief period in 2000 and 2001 when the OECD began publishing a blacklist of 35 secrecy jurisdictions (though notably neglecting to include any of its own members on the list). This spurred some real reform on the part of many offshore havens seeking to escape the growing criticism and notoriety that came as a result of their inclusion on the list. Unfortunately, the project was abandoned in 2001 at the behest of the George W. Bush

²⁸ Ibid., 221-31.

²⁹ Ibid., 221-23.

³⁰ Ibid., 223-24.

³¹ Global Witness, *How FATF Can Measure and Promote an Effective Anti-Money Laundering System*, (London and Washington: Global Witness, 2012). Available at <http://www.globalwitness.org/sites/default/files/library/How%20FATF%20can%20measure%20and%20promote%20an%20effective%20anti-money%20laundering%20system.pdf>.

³² Shaxson, 226.

administration.³³ But that only revealed just how much influence the United States can bring to bear on the global offshore system; if one administration shut reform down, a future administration can start it back up. Of all external actors who must play a role in this process, the United States is paramount (along with the UK).

Of course, the fact the Bush administration moved against the OECD blacklist was a concession to the huge financial institutions and Big Four accounting firms that serve most of the world's offshore clients. And herein lies both the problem and solution. Under normal circumstances, no OECD government that plays host to these firms – including the United States, the UK, and others – can be expected to enact reforms that would attack their interests so fundamentally. Fortunately – at least for the cause of weakening offshore – most of these institutions are prone to shoot themselves in the foot through disastrous financial bets and other scandal-generating activities. When this happens again – and it will at some point – they will find themselves politically weaker and less able to obstruct lasting reform. In this regard, the financial crisis of 2007 to 2009 was an enormous lost opportunity, not only for ending offshore but for breaking up the large banks themselves and thereby permanently eroding their hold over OECD governments (which would make it easier to undermine the offshore system, among other reforms).³⁴

But another crisis will eventually happen. When it does, there will be at hand a great opportunity to cripple the influence of the status-quo actors seeking to prevent meaningful institutional change. It will be up to our leaders to seize it – and to all of us to make sure that they do.

³³ Shaxson, 149-62.

³⁴ Johnson and Kwak, 2010.

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Appendix I. Indicators of Privatization Fraud

Below is a list of the various indicators of privatization fraud that were used to conduct the analysis of the ten largest privatizations in each country. The first set of indicators are each considered sufficient on their own to indicate fraud. The second set consists of indicators that, while suggestive of fraud, must be verified by the presence of one or more indicators from the first group in order to be considered meaningful.

Group One: Sufficient Indicators

1. No-bid privatization: In a no-bid privatization, the rules governing the privatization formally exclude any competition. Instead, only one buyer is allowed to participate and the privatization contract is awarded to that buyer. To be sure, some privatizations may not attract sufficient interest from more than one bidder. But when it comes to the largest and most valuable firms the state has to offer, we should necessarily expect multiple parties to take interest. If the government awards the privatization without any formal bidding process, this is highly suggestive of fraud.
2. Competition allowed but arbitrary measures taken to limit competition: Unlike a no-bid privatization, in this case the rules governing the privatization do allow for competition among potential buyers (unlike a no-bid privatization). However, the government uses arbitrary measures in order to disqualify certain participants or persuade them not to participate. Below are some common examples of arbitrary measures taken to limit competition:
 - *Eligibility restrictions*. An eligibility restriction is a formal, written requirement that an interested participant must meet in order to take part in the privatization.
 - Certain kinds of eligibility restrictions are perfectly legitimate. For example, the government might require that any participant in a privatization have a certain amount of capital or be able to show a formal guarantee from a bank confirming their ability to make the payment.
 - Other kinds of eligibility restrictions are “abnormal” and suggest that somebody is trying to corruptly limit participation in the privatization to benefit a certain buyer. One can often tell the existence of such restrictions because they are quite narrow and “technical” and do not appear to be justified by any rational economic consideration. For example, the rules might limit participation only to companies that paid at least \$50 million in taxes in 1997 and no more than \$3 million in taxes in 1998. Any company that paid less than \$50 million in taxes for the year 1997 and/or paid more than \$3 million for the year 1998 finds itself ineligible to participate. This requirement makes no economic sense at all and is clearly intended to benefit one particular

company allied to the government that just happened to pay \$51 million in taxes for 1997 and \$2.7 million in taxes for 1998.

- In other cases, eligibility requirements that ordinarily are legitimate are applied selectively in order to prevent certain potential buyers from participating. For example, one interested party is disqualified because it cannot provide a bank guarantee while another company is allowed to participate despite the fact that it too cannot provide a bank guarantee.
 - *Ambiguous rules*: In this instance, the government deliberately structures the rules so as to create uncertainty among potential participants on whether their property rights will be secure if they win the privatization competition. For example, a rule is adopted stating that, in the event that the privatization is awarded to a foreign company, the government retains the right to re-privatize the firm to a domestic buyer at some point in the future. The intention here is to scare away potential foreign buyers so that they do not provide unwanted competition to the government's preferred buyer (even though the rules formally allow for foreign participation).
 - *Threats*: Sometimes threats and intimidation are used to persuade certain interested parties from participating in the privatization.
 - *Physical restrictions*: In this case, the government resorts to physical restrictions on the ability of anyone except a pre-designated buyer to participate in the privatization. For example, the local airport in the city where the privatization is to take place is suddenly closed on the day of the privatization so that competing bidders cannot get there.
 - *Limited information*: A frequent practice in corrupt privatizations is for the government to limit information regarding the privatization so that unapproved parties are unable to participate. Perhaps the privatization auction was not publicly announced so that only certain allies of the government know that it will take place. Or maybe it was announced but the time and/or location of the auction was not disclosed.
3. Non-transparent privatization: "Limited information" above refers to limitations on key information *before* the privatization takes place (in order to prevent unwanted competition). In a non-transparent privatization, the government restricts the disclosure of information about what happened *during* the privatization. Whenever the government conceals key information from the public about what happened in the privatization, this suggests that fraud has taken place. Almost always, there is no economically rational reason for limiting such information except to conceal the fact that the sale was fraudulent. Types of information that the government might want to hide might include:
- Who participated in the privatization
 - The different bids offered by the various participants (in this case, the government might want to conceal the fact that the winning bid was worse than competing offers)
 - Who won the privatization: When the government will not even disclose who won the privatization, this usually suggests that they sold the

company either to one of the government's own members or a key ally of the government.

- The payment terms of the privatization contract: Sometimes the government does not reveal the terms by which the winner of the privatization will pay for the privatized firm. What amount did the winner agree to pay? In the event that the whole payment does not have to be made at once, what was the amount of the down-payment (the portion of the payment that must be paid up-front)? Over what period of time will the remainder of the payment be made? This is information that the public should have the right to know. When the government does not announce it, it is usually because the privatization was awarded to a government crony on very easy terms and the government does not want anyone to know this.
4. Winner is previously unknown or marginal: Sometimes, the winner of a privatization is an individual or company that nobody seems to have heard of before. Alternatively, the winner was previously a very small actor in the business world. When this happens, it indicates that corruption took place. This is especially true for the very biggest privatizations of the kind under consideration here. When a large privatization is conducted fairly and legally, it is inconceivable that a previously unknown or marginal actor is suddenly able to offer a more competitive bid than other, more well-established participants. When the winner of a privatization appears to have emerged out of nowhere to win the contract, this suggests that the winner benefited from inappropriate government favoritism.
 5. Clear political interference in the conduct of the privatization: In an honest, non-corrupt privatization, the relevant government agency in charge of the privatization should be able to carry it out without any outside interference. When there are clear indications of interference by powerful individuals who have no official role inside the privatization agency, this suggests that corruption is taking place. Interference might come from the president or prime minister, other government ministers, the leaders of the main political parties, a foreign state, or powerful businesspeople. They will often try to influence who can participate in the privatization and/or who wins the privatization.
 - In doing so they might even overrule the opinions of technical specialists in the privatization ministry about who has made the best offer. If the judgments of such specialists are indeed disregarded, this provides further evidence that the privatization was corrupt.
 6. Winning bid worse than competing bids: When the offer made by the eventual winner of the privatization was substantially worse than the offers made by other participants, this clearly suggests that fraud has taken place. However, price is not always the only legitimate element of a bid; even if the winner offers a lower price than competitors, other considerations such as the financial strength and

economic compatibility of the bidder may also be taken into account without necessarily indicating that corruption occurred.

7. Winner holds a position in the government and/or ruling coalition: When the winner of the privatization has an official position in either the government itself or a political party that belongs to the ruling coalition, this indicates that corruption took place. Any honest privatization process would on principle exclude those serving in an official role from participating.
8. Winner is a relative of somebody in the government and/or ruling coalition: The same is true if the winner is a relative of somebody in the government and/or ruling coalition.
9. Winner made illegal campaign contributions to ruling coalition and/or president: When the winner made a campaign contribution to an elected official in violation of the laws governing such contributions, this is highly suggestive that the privatization involved corruption. Many people who make *legal* donations to election campaigns do not necessarily expect to receive corrupt benefits as a result of their financial support. But making an *illegal* money contribution involves a significant risk. Nobody would take this kind of risk unless they expect to receive something in return.
10. Winner is the same individual in charge of running the privatization: One of the most blatant signs of privatization fraud is when the same individual who is placed in charge of administering the privatization ends up winning that privatization. This individual could be the government minister in charge of privatization but might also be a private businessperson whom the government appointed to organize the privatization auction.
11. Winner purchased the firm with state money: One of the official aims of privatization is to raise money for the state budget. But when the winner of the privatization used state money to purchase the company, it defeats the purpose of the privatization. It suggests that some other agenda besides raising revenue drove the government's decision to privatize the firm. Sometimes the buyer borrows the money from a state bank (which does not necessarily mean corruption took place but is certainly suggestive). Other times the buyer was simply granted the money by the state to buy the firm (or stole it from the state). In the latter case, fraud most certainly took place.
12. Company sold at a major discount to stock market value at the time of sale: It is often difficult to determine whether a state company was sold for an unjustifiably low price. The reason is that it the precise question of what constitutes a "fair" price is a complex one to answer. However, it becomes easy to do if the company, at the time of the privatization, already had shares that were publicly traded on the stock exchange. If so, it is possible to compare the company's stock

price, which represents its current market value, to the price that was paid in the privatization.

13. Official inquiries blocked or shut down: Allegations that a privatization was corrupt can sometimes lead official state bodies to initiate a formal investigation into whether a crime occurred. But when these investigations encounter political interference – or are shut down entirely – this indicates that fraud did occur and some powerful individual is trying to conceal it.

Group Two: Non-Sufficient Indicators

1. Competition allowed but with limits on foreign participation: In this case, the rules do allow for competition. But the rules also impose certain limitations on foreign bidders or entirely prohibit them from participating. Domestic bidders do not face the same limitations. This may suggest that fraud was involved. On the other hand, governments often try to keep certain industries in the hands of domestic owners for reasons other than corrupt links with the buyer.
2. Multiple participants linked to the same individual: Sometimes the government wants to make sure the privatization is awarded to a preferred buyer but wants to create the appearance that there is real competition taking place. As a result, its preferred buyer (Company A) will set up a second company (Company B) that is supposedly separate from Company A. But Company B is in fact owned by Company A or somebody close to Company A (a relative, a partner, etc.). Nevertheless, the mere presence of multiple participants linked to the same individual does not by itself imply some sort of corrupt connection between the participant and the government officials in charge of the privatization.
3. Winner immediately sells to a non-participant: This is another way to create the appearance of competition when, in fact, competition is limited. The government intends to give control of the state-owned firm to Company A. But Company B, which is separate from Company A, is also allowed to participate in the privatization and ends up winning the contract. But soon after winning the privatization, Company B sells the privatized firm to Company A in a pre-arranged deal. Note here that Company B is indeed separate from Company A; it is not owned by Company A or anyone linked to Company A. But there was clearly some deal made between the two companies to make sure that the privatized firm ended up in the hands of Company A. Again, however, it does not necessarily imply a similar deal between the buyer and the government officials in charge of the privatization.
14. Owners of the winning firm are unknown/not disclosed: In this case, the identity of the company that won the privatization is publicly announced. But nobody seems to know who the real owner of this company is. The fact that the owner (and the government) wish to conceal his identity suggests that he won the

privatization through dishonest means. But it does not necessarily imply this was the case.

15. Allegations of corruption: Allegations, whether made by newspaper reporters, politicians, or state officials, may indicate that the privatization was corrupt. On its own, however, this indicator is not sufficient to draw such a conclusion.
16. Winner is a friend or close ally of somebody in the government and/or ruling coalition: If the winner is reported to be a friend or close ally of somebody in the government and/or ruling coalition, this may indicate that fraud took place. But it does not by itself imply that fraud occurred.
17. Winner made legal campaign contributions to ruling coalition and/or president: Such contributions do not necessarily mean that corruption took place, but it is suggestive if combined with other indicators.
18. Winner made campaign contribution within 6 months of winning the privatization: When somebody who wins a privatization is reported to have made a contribution (whether legal or illegal) to the ruling coalition and/or president just before the privatization, this suggests the privatization was part of a pre-arranged deal. The same is true if the contribution was made very soon after the privatization took place. Nevertheless, we cannot conclude the occurrence of fraud on the basis of this fact alone.
19. Winner is a company insider: When the privatization is sold to a member of the company's own management, this can (but does not always) suggest fraud.
20. Previous privatization cancelled and shares resold to government ally: A government might decide to cancel a previous privatization of a company for a variety of reasons, some of which are perfectly legitimate. For example, if the previous privatization is ruled to have been corrupt, the government might take the company away from its owners and re-privatize it again under fair conditions. But if the individuals who win the new privatization are known to be allies (or members) of the government, this suggests that the re-privatization process might have been corrupt.
21. Winner sells firm within 3 years: When the winner of a privatization sells the company within three years for a much higher price than he paid for it, this can indicate that the price he initially paid was unjustifiably low. On the other hand it may reflect a significant restructuring of the firm that occurred in the interim.
22. Individuals involved in the privatization arrested, charged, prosecuted, convicted, and/or imprisoned for a crime: If anybody involved in the privatization faces punitive action by the state for a crime relating to the privatization this may suggest fraud. On the other hand, such action may have been undertaken on

political rather than legal grounds, perhaps as part of an attempt by a powerful individual to marginalize a rival.