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## **Policies First, Institutions Second: Lessons from Estonia's Economic Reforms**

Neil A. Abrams<sup>a\*</sup> and M. Steven Fish<sup>a\*</sup>

<sup>a</sup>Department of Political Science, University of California, Berkeley

It has become convention in recent years to treat the building of institutions as the centerpiece of successful economic reform. The case of Estonia challenges this view. Although effective economic institutions eventually arose, Estonia began its transition bereft of the institutions that supposedly serve as the requisites of robust achievement. The institutions only emerged after an ideologically-driven core of leaders implemented policies that laid the groundwork. In particular, the imposition of hard budget constraints sidelined political capitalists opposed to the rule of law by severing them from the state subsidies, soft loans, and other privileges on which they thrive. In the absence of a powerful class of political capitalists, Estonian governments were free to forge and continually improve a collection of institutions that sets the country apart among its postcommunist peers. Good institutions are desirable but not necessary for policy reform, and they are better seen as auspicious knock-on effects than as prime movers.

Keywords: Estonia, institutions, postcommunist economic reform, property rights, corruption

### **Introduction**

Writings on economic transformation in developing countries, including those emerging from decades of Soviet-style economic statism, often treat the building of institutions as the centerpiece of successful economic reform. According to such thinking, in order for economic reforms to yield improvement rather than disorder and opportunities for predation, a sound set of well-enforced rules is needed. Since authoritative rules take time to develop, analysts who stress the critical importance of institutions often counsel skepticism about radical, rapid policy reform.

Such institutionalism predominates in academic discussions. Its suppositions, however, have come under challenge in light of important real-world cases. Some of the most successful cases of economic takeoff in recent decades have occurred in countries that were bereft of the institutions that supposedly serve as the requisites of robust achievement. There was little institutional infrastructure for a market economy in China

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\* Corresponding authors. Email: [neil8507@gmail.com](mailto:neil8507@gmail.com); [sfish@berkeley.edu](mailto:sfish@berkeley.edu)

when Deng Xiaoping initiated his liberalization in 1978, and the explosive growth that ensued continued for years before anything resembling strong institutions appeared. Deng knew that he wanted China to escape poverty and that hard statism was yielding penury, but he could not rely upon sophisticated rules, agencies, and personnel during the early years of the reforms. China has since undertaken institutional reforms and innovations and produced a cadre of savvy technocrats. But these desiderata emerged well after Deng's sudden, dramatic turn to the market took place. The institutions emerged from the policy reforms and their fruits, not vice versa (Fish forthcoming).

The notion that getting the institutions right is the *sine qua non* of successful economic transition nevertheless persists, not least among specialists on East Europe and the former USSR. Many blame the economic disasters that befell the region during the 1990s on radical reforms taken in haste, before the proper ensemble of institutions needed to secure property rights and guide the new economies' management were in place (Amsden, Kochanowicz, and Taylor 1994; Cohen and Schwartz 1998; Firestone 2008; Florio 2002; Herrera 2004; Johnson 2000; Roland 2000; Schwartz 2006; IBRD & The World Bank 2001; Stiglitz 2002; Rodrik 2003, 2008).

By institutions, most analysts mean formal rules, and we also adopt such a conception. "Institution" is one of the most elastic concepts in social science, and has sometimes been distended to mean virtually anything under the sun. While recognizing the contributions of authors who have recently developed notions of "informal institutions" and of older generations of authors who sometimes treated political parties and other organizations and state agencies as "institutions," we follow John Carey in applying the concept solely to what Carey calls "parchment institutions," meaning formal rules, expressed as laws or regulations (Carey 2000). Our definition is consistent with what is often used in rigorous mainstream political science (Mahoney and Thelen 2010; Desposato and Scheiner 2008). It works well for the purposes of our article. It is, after all, the absence or weakness of the proper rules needed to govern the economy prior to major policy change that institutionalists blame for the corruption, predation, and poor performance that have afflicted many economies in the postcommunist world and other regions.

If an institution refers to rules, a *policy* is a set of actions (or inaction) by the government in the treatment of a public problem. This definition is consistent with the various ways scholars have defined the term (Birkland 2015, 7-10). A policy may involve the creation of an institution, but need not do so. Additionally, a policy can eventually become an institution to the extent that it gets codified into law. Nevertheless, we maintain a strict analytic and conceptual distinction between institutions (rules) and policies (actions).

Here we question the logic of the institutionalist approach. We do so on the basis of our analysis of post-Soviet Estonia. Estonia began its economic transition with none of the economic institutions that are often considered requisites of successful economic reform. But it did have a clique of new leaders who were strongly committed to policies that neutralized resistance by corrupt business actors to the creation of market-supporting institutions. The outcome in Estonia was a continual process of building, simplifying, and improving rules, regulations, and the agencies that enforced them.

Two sets of policies proved critical. The first, begun even before the USSR's demise, consisted of personnel replacements and the construction of state agencies that

would provide an embryonic structure for a new bureaucracy. But these measures would never have yielded effective institutions were it not for the second policy: the imposition of hard budget constraints (HBCs) upon firms. HBCs helped forge an economic arena in which political capitalists, meaning actors who make their fortunes by dint of their political connections, remained relatively marginalized when compared to their status in other postcommunist countries. The prominence of entrepreneurs rather than political capitalists in economic life, in turn, subsequently helped create a political environment in which leaders could forge authentic, effective institutions without being stymied or corrupted by formidable economic interests that thrived on state subsidies, soft loans from state banks, special tax status, privileged market access, and other favors afforded by proximity to political power.

By the late 1990s and beyond, sound rules for regulating property rights and market transactions did emerge. Indeed, Estonia became and remains the leader in economic-institutional development in the postcommunist region. Still, like in China, some simple, radical policy changes, launched by a handful of committed reformers, predated and enabled the nascence of market-nurturing institutions. The absence of good institutions did not impede or pervert successful reform, and good policies are what made good institutions possible.

Thus, we find that good institutions for governing the economy are sooner the *effects* of good policies than the *causes* of them. We further find that the adoption of good policies depends on the presence in high political office of an ideologically committed cadre of leaders who are able and willing thoroughly to see the policies through to the end. In our causal argument, politicians, by virtue of their commitment to a policy of HBCs, determine which types of economic actors will predominate in the new economy, which in turn shapes the possibilities for the enactment and authenticity of the institutions that govern the economy. The personnel and organizational policies helped lay the groundwork for the new institutions but would never have borne fruit had HBCs not weakened resistance to those institutions by political capitalists. We offer an actor-centered story in which the principles and interests of people determine the quality of institutions, rather than vice versa. Good institutions are desirable but not necessary for policy reform, and they are better seen as auspicious knock-on effects than as prime movers.

At the onset of Estonia's transition, the country was bereft of even the basic trappings of statehood, and still more of the institutions associated with a well-functioning market economy. Until the late 1990s, Estonia endured a period of severe institutional flux. Broad areas of market-related law—not to mention the capacity to enforce the law—remained inchoate at best. Like elsewhere in the postcommunist region and other countries during early capitalism, this circumstance created fertile ground for political capitalism. But Estonian political leaders' dedication quickly to imposing HBCs undermined the sorts of economic actors who so often thwart the enactment of market-nurturing institutions or encourage the adoption of Potemkin institutions that might look good to external donors but do not truly foster the emergence of a vigorous, competitive market economy.

### **Hard Budget Constraints and the Estonian Transformation**

Political transition in Estonia took the form of wholesale replacement of the communist regime and its agents. No formal negotiations with the ruling communists occurred. The process began with the victory of the Popular Front of Estonia in the first fully free parliamentary elections, held in 1990 while Estonia was still part of the Soviet Union. After the breakup of the USSR, a transitional government was appointed under Tiit Vähi. In the first post-Soviet elections, held in September 1992, a coalition led by Mart Laar came to power. In these elections, the reform-communist Left Opportunity failed to make the five-percent threshold. Only 35 percent of the deputies in the 1992 parliament had previously belonged to the communist party during the Soviet period and substantially fewer than that had been members of the *nomenklatura*. 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 apparatus. Thus, by the autumn of its first full year of independence, the Estonian government was under the full control of a revolutionary counterelite (Steen and Ruus 2002; Kionka 1992). Estonia's new leaders espoused an ideology that viewed national sovereignty, regime change, and radical economic transformation as mutually interdependent imperatives.

How, then, did Estonia's early postcommunist governments lay the foundation for the permanent marginalization of political capitalists, while so many other postcommunist governments, including those in which a good deal of new blood came to top government positions, failed to do the same? The answer is that the radical program of HBCs carried out by early Estonian governments (particularly Laar's) cut off the emerging class of political capitalists at the knees. These policies were highly unusual in the postcommunist region; even in some countries that have been widely regarded as reform leaders, the imposition of HBCs was half-hearted and took a back seat to other reform priorities. In Czechoslovakia and, later, Slovakia, for example, persisting soft budget constraints (SBCs) enabled political capitalists to amass great wealth and influence (Gould 2011, 76-89, 103-32).

Nothing of the sort would happen in Estonia. The speed and depth of its governments' commitment to HBCs is revealed in Table 1, which shows how far different postcommunist governments went in hardening budget constraints as of the second year of the transition. The data are derived from the EBRD's Transition Indicators and takes the average score on the three indicators that relate specifically to HBCs (enterprise restructuring, price liberalization, and banking sector reform). Estonia emerges far ahead of every other country.

#### INSERT TABLE 1

According to the conventional view, a firm has an SBC if it can access external support to fill the gap between its income and expenditures (Kornai 1979, 1992, 2001; Kornai, Maskin, and Roland 2003; Maskin and Xu 2001). As such, under the standard definition only a *loss-making* firm can have an SBC. But across the postcommunist world one can observe plenty of *profitable* business actors receiving outside assistance. These companies benefit from the same kinds of state subsidies, special tax breaks, and soft loans that provide SBCs to loss-makers. Often it is pointless to distinguish between external assistance to loss-making and profitable companies; subsidies to a loss-making

coal mine pass right into the coffers of an oligarch-controlled firm that transacts on lopsided terms with the mine, or the state bails out an insolvent bank that then proceeds to grant cheap loans to rent-seeking business elites. Each is obviously an example of an actor taking advantage of an SBC.

Therefore, under our definition, *any* firm, whether loss-making or not, which receives artificial external support not justified on grounds of economic rationality qualifies as having an SBC. If the firm can access these benefits only through an arms-length transaction and at the market price, it has an HBC.

SBCs take the following forms: (1) state subsidies, which can include not only direct state transfers to insolvent firms but also underpriced privatizations and overpriced state contracts to government cronies; (2) soft taxation, or the granting of special exemptions from taxes and duties; (3) soft financing, or the issuing of debt or equity on artificially lenient terms; (4) indirect mechanisms of support, meaning those that benefit the recipient only by first altering economic or political conditions in ways the recipient can take advantage of (e.g. excessively complex regulations that insiders can evade at the expense of outsiders); (5) soft trade credits among firms; and (6) wage arrears.

HBCs primarily involve *policies*: reining in state subsidies, special tax breaks, excessive bank lending, soft trade credits, and wage arrears while simplifying regulations and rules which might artificially benefit the politically-connected. But in addition to policies, HBCs require the introduction of two key institutions: sound banking supervision and a bankruptcy law. State bodies tasked with enforcing these rules must likewise be established—namely a banking regulator and bankruptcy courts.

While HBCs do require certain institutions, the range of these institutions is limited to the realms of banking and bankruptcy. Crucially, the restricted nature of HBC-related institutions contrasts sharply with the all-encompassing framework proposed by some institutionalists, which encompasses everything from effective courts and property-rights institutions to insurance schemes and rules for enhancing transparency. These other institutions can eventually develop once HBCs have sidelined political capitalists. Until then, however, the institutionalist aspiration to transplant West European-style institutions onto early-capitalist societies will likely remain a pretty dream.

The SBC phenomenon is related to rent-seeking, defined as the pursuit of unearned income. But the two concepts are hardly coterminous; while all SBCs are examples of rents, not all rents are examples of SBCs. Rent-seeking is a much broader concept that includes activities that have nothing to do with external support to firms in the form of state subsidies, soft taxation, and the other SBC instruments noted above. Organized criminal protection rackets, bribe-taking by state officials, market corners, pump-and-dump stock-market schemes, and selling snake oil all constitute rent-seeking but do not provide SBCs.

It is difficult to identify structural factors that explain why Estonia's leaders imposed rigorous HBCs while their Czech and Slovak counterparts, for example, did not. Why did the Klaus government in the Czech Republic remain so obsessed with its program of rapid privatization to the detriment of reining in SBCs in the financial system (Gould 2011, 81-9) 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 commitments of Laar and his colleagues. Neither government slavishly followed the advice of Western advisors (Appel 2004, 105-6; Arias-King 2003, 499-500). Nor did they

passively respond to domestic conditions. The Klaus government compromised on HBCs out of a desire to win the 1996 elections (Gould 2011, 86-7), but that was a matter of choice; the Laar government was willing to sacrifice political survival for the sake of the reforms' success (*Washington Post*, 21 June 1993). It bears note that Laar returned as prime minister for a three-year stint in 1999-2002.

Estonian leaders were hardly aware of the full implications of their commitment to HBCs. For them, a market economy required that firms could survive without state support, and this belief made HBCs a central component of the government's market reforms. It is highly unlikely that they explicitly intended to use these policies to marginalize corrupt business actors who might otherwise sabotage the development of sound property rights. But Regardless of its intentions, the new government did rapidly harden budget constraints, and the economy and polity reaped the benefits thereof.

In a dramatic departure from the practices of most other postcommunist countries, the Laar government actually shut down insolvent state banks. It subjected the remaining banks to an effective regime of financial supervision. These policies prevented the out-of-control lending so common in other postcommunist countries, including those that gained reputations as rapid reformers. The draconian banking reform was launched in the summer 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 was closed later (The Economist Intelligence Unit [EIU] 1993a, 1993b). Most of the smaller state banks, particularly those in trouble, were shut down or allowed to fail. As early as the beginning of 1993, seven banks whose capital adequacy ratios did not meet the government's strict requirements had already seen their licenses revoked (EIU 1993a, 1993c). 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 agencies time to develop their capacity to control the new banking sector (EIU 1993d). As a result, non-performing loans rapidly became a miniscule portion of all loans. As Table 2 shows, Estonia's performance in this respect was exceptional.

## INSERT TABLE 2

The lending moratorium on the big state banks allowed new private ones to spring up in their place, and effective regulatory supervision prevented excessive lending by the new banks. Through steady, conservative management, the fledgling private banks' 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 Aavo Kokk, head of the Taxation Department in the Ministry of Finance in 1992-93 and subsequently a manager at the Estonian Savings Bank. "Generally the top management of the old banks were among the first to leave" (correspondence with Kokk, 26 November 2008; EIU 1994c).

By mid-1994, a relatively strong and financially healthy banking sector had emerged (EIU 1994b, 1994c, 2007). The early adoption of a currency board to regulate the money supply under a fixed exchange rate aided the process. Among its other accomplishments, the currency board ensured that financially troubled banks could not

rely on state-sponsored bailouts in the event of failure (Fleming, Chu, and Bakker 1996, 8-9).

In addition to preventing excessive bank lending, the Laar government implemented an effective policy of enterprise restructuring. The program's centerpiece was a sound and well-enforced bankruptcy law (EIU 1994a). As early as mid-1993, the Ministry of Economic Affairs 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 (Fleming, Chu, and Bakker 1996, 20). Bankruptcies began increasing on a large scale in 1994 (EIU 1994a). "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 (Fleming, Chu, and Bakker 1996, 20).

Successive governments also resisted the temptation to subsidize politically connected firms. With a few notable exceptions, state companies in Estonia do not serve as cash cows for influential elites like they do in other postcommunist countries, according to a source who prefers to remain anonymous (author's interview with Respondent #1).<sup>1</sup> Furthermore, by instituting a 26 percent flat tax in 1994, the government deprived firms of the opportunity to receive politically-engineered tax breaks (Nørgaard and Johannsen 1999, 131-33). The Laar government rigidly adhered to its policy despite fierce (and predictable) opposition from some political opponents (Lieven 1993, 359-60).

Thus, early Estonian governments not only refrained from propping up state banks but also refused to provide special treatment to other state-owned enterprises. They thereby confounded the expectations of some economists who hold that privatization is a necessary condition for HBCs (Schmidt 1996; Frydman et al. 2000; Roland 2000). If the Estonian experience is any guide, state as well as private firms can face the wrath of market competition if the government is sufficiently committed to disciplining them.

### **The Fruits of Hard Budget Constraints: Entrepreneurs, Not Political Capitalists, Prevail in the Economic Arena**

The main result of the policy, for the purposes of our story, was to shape an economic arena that severely limited opportunities for political capitalists. HBCs constrained opportunities for the government to enrich politically connected firms with state funds.

In the absence of HBCs, Estonia likely would have given birth to the same type of political capitalism and economic criminality that has prevailed in other postcommunist countries. Like elsewhere in the region, organized crime flourished in Estonia in the late 1980s and early 1990s. Criminal groups profited by extorting protection money from the legal business sector. They also derived revenues from illegal businesses and especially smuggling, which was particularly lucrative given Estonia's position as a seaport for Russian exports. But the criminals and former secret service officials who profited from these schemes failed subsequently to dominate economic activity in Estonia, since they

found themselves largely cut off from state assets (Lieven 1993, 325; Nørgaard and Johannsen 1999, 117-20), the most lucrative source of illicit wealth in postcommunist countries. The stringent HBCs that Estonia's governments imposed in the early postcommunist setting robbed political capitalism of its lifeblood. They enabled the emergence of a real market economy, dominated by entrepreneurs rather than actors who rely primarily on connections to the state.

A handful of individuals with backgrounds in organized crime did manage to legalize their assets and move into legitimate business in Estonia. Among these, according to an anonymous source, was a prominent criminal figure from the early 1990s who went on to own a hotel and convention center in suburban Tallinn (author's interview with Respondent #2). Meelis Lao, another businessman alleged to have past links to organized crime, has appeared on lists of the top-100 richest Estonians in recent years (*Äripäev*, 18 September 2009 and 4 June 2010; *Central European Review*, 30 April 2001).

A few people from the communist establishment also made it onto these lists. Rein Kaarepere, a former member of the Soviet-era Council of Ministers, founded the Tartu Commercial Bank in 1988 with the help of his Communist Party connections. It eventually failed and in 1993 was shut down by the central bank. Kaarepere later joined Hansapank, where he was the lone ex-communist among the senior management (*Eesti Ekspress*, 16 January 1997; author's interview with Enno Tammer, 5 November 2008).

Still, the government's policy created negligible opportunities for would-be political capitalists, and relatively few made it to the top of the business elite. At the onset of the 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 the Vähi government; and Uno Veering, another red director and a deputy prime minister in the Vähi government. (The fourth family was made up of Canadian émigrés.) Much of their wealth came from having bought up valuable real estate at low ruble-denominated prices and profiting from the subsequent rise in value (Lieven 1993, 101). Except for Taal, however, none of them remain on *Äripäev's* list of the top-500 Estonians today. The SBCs that these actors relied upon in the late communist period quickly dried up after independence.

Indeed, with a few notable exceptions, most former communist officials who tried their hand in business did not rise to the top. 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" (author's interview with Raidla, 17 November 2008). 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 communist officials, Kokk states, enjoyed advantages very early in the transition and privatized enterprises thanks to their inside knowledge of how much the companies were worth. Still, Kokk adds, "not all of them were able to run these companies well" (author's interview with Kokk, 14 October 2008). And that is precisely the point: In an environment of SBCs, such as commonly prevailed elsewhere in the region, running one's company well would not have mattered to the politically well-connected. But in Estonia, ex-communist officials

by and large had to deal with the same competitive conditions that other business owners faced.

Thus, individuals who made money by virtue of their business acumen rather than their political connections assumed prominent places in Estonia's postcommunist economy. We may consider these people entrepreneurs rather than political capitalists. Viktor Levada established Levadia Metall and turned it into the largest metal trader in Estonia, although it went bankrupt in 2011 (author's interview with Peeter Raidla, 10 November 2008; *Baltic Business News*, 13 April 2011). Mati Polli, Peeter Mänd, and Kaido Jõelet built up Sylvester, a timber and paper producer, from modest beginnings and did so without relying on political connections. They later cashed out to a Finnish investor (*Äripäev*, 15 August 2013; author's interview with Sulev Vedler, 18 September 2008). Tiit Aava, who died prematurely in 2013, was a respected real estate developer and construction magnate. In the 1990s he bought substantial tracts of real estate, and 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 essential in his rise to riches (*Eesti Ekspress*, 21 February 2013).

Vello Kunman reportedly made his first million running a vegetable farm while still a student. His ticket to the top 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 (*Eesti Ekspress*, 26 June 2008). Other businesspersons whom an anonymous source named as donors to political parties include Armin Karu and Jaan Korpusov (author's interview with respondent #3). But they constructed Olympic Entertainment Group, their casino empire, from the ground up in the 1990s before establishing political contacts (*Baltic Business News*, 26 February 2008; author's interview with Sulev Vedler, 18 September 2008). 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, his main competitor (mentioned above) (*Mees*, 19 October 2008; correspondence with Peeter Raidla, 7 July 2014).

Other examples abound. They include Igor Izraeljan, owner of Technomar & Adrem, a timber processor, and Hillar Teder, who developed a major hypermarket chain operating in Russia and other countries around the region (*Äripäev*, 10 February 2004; author's interview with Peeter Raidla, 10 November 2008; author's interview with Sulev Vedler, 18 September 2008).

To be sure, not all of Estonia's entrepreneurs have kept their hands clean after acquiring wealth. For example, Hans Luik, the builder of Ekspress Group, a media empire, has been accused by credible sources of dubious practices. In 2008, articles appeared describing Luik's apparent involvement in loan-sharking operations (*Baltic Business News*, 27 March 2008 and 7 April 2008). While his reputation has been tainted, Luik, like most members of Estonia's economic elite, built his fortune without close association with the state (author's interview with Peeter Raidla, 10 November 2008).

While most of Estonia's postcommunist economic leaders are Estonians, some immigrants have prospered as well. Originally from Singapore, Sonny Aswani became an Estonian citizen in 1999. He made a fortune in paper products and textiles after privatizing companies, some of which were bankrupt, in the mid-1990s (*Ärileht*, 3 May 2006). Peter Hunt, an Estonian raised in Sweden, came to Estonia in the mid-1990s and began importing fabrics from Asia. He privatized a carpet factory that would serve as the foundation of Wendre, a multinational textile producer that sells to chains such as Ikea, Carrefour, and Desko. Political connections played no role in his success; he is a simple case of an entrepreneur who succeeded by producing in large quantities and selling at low prices (*Postimees*, 3 July 2010). Finnish-born Joakim Johan Helenius moved to Estonia in the early 1990s and founded Hansa Investments in 1992. The firm, since renamed Trigon Capital, has helped channel Scandinavian money into Estonian investments. There is little evidence that political connections played a role in his success (*Postimees*, 7 May 2005).

### **State from Scratch: The Construction of a Bureaucracy**

As Estonia's new leaders marginalized political capitalists by instituting HBCs, they also undertook personnel changes that would transform Estonia's bureaucracy and help sustain the reforms. Above, we noted some of the early changes in government that occurred at the time of independence. Here we take a closer look at the way reformers reshaped state agencies and their personnel. Some of this activity took place even before Moscow relinquished control over Estonia as the Soviet Union dissolved at the end of 1991.

In the late 1980s and early 1990s, Estonia faced the same problems seen everywhere else in the region. Private economic activity had already begun but the country did not have the institutions to regulate it. Informal markets and criminal activity were flourishing. The economy was in tatters. Salaries of state personnel were low, while professional civil servants versed in European-style governance and jurisprudence could scarcely be found.

While Estonia did not have much in the way of a basis for market-supporting institutions, it made up for this with a critical mass of leaders who were both dedicated to radical policy change and adept at a kind of stealthy, insurgent state-building. Four people in particular played key roles in refashioning state agencies: Edgar Savisaar, Jüri Raidla, Jaak Leimann, and Raivo Vare. Bureaucratic reform and personnel replacement was complicated and took place in the fog of the slow-motion collapse of the USSR. But these reformers and their colleagues managed to begin taking over the Estonian branch of Gosplan, the master Soviet economic planning agency, beginning in 1988 and 1989. At the same time, they worked to establish parallel ministries that would render Gosplan irrelevant and take on its functions. They also created a State Chancellery, under Leimann's direction, that helped coordinate efforts to remold the bureaucracy in charge of the economy. The State Chancellery became, in Vare's words, an "incubator" for a broad range of brand new state agencies and the reorganization of existing ones (author's interview with Vare, 18 November 2008).

From 1989 onward, substantial changes in the state and its personnel began to unfold. Scores of long-serving officials were dismissed under the guise of

“reorganization” while a process of hiring new ones was swiftly instituted. “So it was a kind of parallel process,” Vare recalls, involving “the creation of new organizational positions, installing new people into these new positions, laying off some people and bringing in new people” (author’s interview with Vare, 18 November 2008).

Some ministries were more malleable than others. The Ministry of Industry, in particular, put up staunch opposition. Not until after independence could the reformers manage to supplant its conservative leadership, which enjoyed broad support from the managers of large state enterprises (author’s interview with Vare, 18 November 2008). But the reformers were able to forge a new Ministry of Economic Affairs, which formally came into existence at the end of 1989. It essentially put Gosplan out of business and assumed many of its functions. Savisaar took control of the ministry in 1990. During that year he also became prime minister following the victory of the Popular Front of Estonia in the USSR’s republican-level elections. The Ministry of Economic Affairs worked with local experts who formed proto-think tanks on economic policy. It nurtured the ideas and personnel that would come to guide the economic administration of post-Soviet Estonia. Aavo Kokk recalls:

Savisaar started to use local think tanks to deliberately create a sort of theoretical framework for the future state. Certain people would become interested in, say, taxes. They would get together and discuss taxation. 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. (author’s interview with Kokk, 14 October 2008)

Another bureaucratic innovation was the creation of 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 in charge of transportation and communication on Estonian territory fought the new one until the abortive coup of August 1991, after which its leaders departed for Moscow. Until that point, two separate ministries operated in parallel to one another (author’s interview with Vare, 18 November 2008).

Initially 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 from nothing. According to Vare, the credit for this feat goes mostly to Tiit Vähi, its first minister (and later two-time prime minister). Vare recalls:

[Vähi] 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-Soviet sympathizers were heavily concentrated] and he basically executed Estonian power there very mercilessly...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.

The role of individual leaders was particularly important under conditions in which agencies were being created from the ground up. Vare continues:

In this kind of embryo structure, we had to handpick people one by one. 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. (author's interview with Vare, 18 November 2008).

Aside from economic affairs, and transportation and communication, another high-priority area 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, which was largely in place by 1990. "All that Laar [who became prime minister in the fall of 1992] had to do was to provide that last push to make it all come together," says Kokk. As the Soviet bureaucracy withered, the proto-finance ministry helped preside over the introduction of an income tax and a VAT (author's interview with Kokk, 14 October 2008).

The people were as new as the agencies they were endeavoring to create. 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 in this department have a legal background. But we just had to build it up somehow" (author's interview with Kokk, 14 October 2008).

Certain agencies 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 agencies were created from nothing and operated in parallel with existing Soviet-era ones. Instead, independent Estonia would inherit its police and judiciary whole from the Soviet system, and the agencies and rules governing them would begin to change only after independence (author's interview with Kokk, 14 October 2008). A comprehensive vetting process implemented soon after the transition resulted in the dismissal of personnel complicit in communist-era repression or who were otherwise corrupt or incompetent. The process helped filter out the kinds of officials who might have served as patrons to budding political capitalists. Still, the Soviet-era judicial system could not be transformed overnight, and it was completely ill-prepared for the new market, according to Helve Särkava, a longtime judge. Criminal justice 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*. It was

not until the late 1990s that judicial capacity finally caught up with the economic activities it was supposed to police (author's interview with Särğava, 6 November 2008).

In the civil courts, too, substantial time was required to develop the rules needed to preside over the new system of market exchange and the expertise needed to enforce those rules. In communist times, civil justice focused exclusively on housing, family law, payment of damages, and work-related disputes. Jurists lacked any experience in corporate litigation, copyright law, contract and bankruptcy law, ownership disputes, and real estate law—the legal mainstays of a market economy. All of these specializations are now part of the standard law-school curriculum in Estonia. But during the 1990s judges had to learn on the job and underwent a two-year retraining program. Post-Soviet Estonian law borrowed heavily from German law, and German legal experts were brought in to assist in the training of judges (author's interview with Särğava, 6 November 2008).

Developing corruption-fighting capacity also took time. 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” (author's interview with Sinisalu, 7 November 2008). Indeed, according to a longtime prosecutor who prefers to remain anonymous, it was easy to get away with economic crimes in the first half of the 1990s since there was no legal framework designating them crimes in the first place (author's interview with respondent #4). A formal civil service code establishing an independent and apolitical civil service was not adopted until 1995 (Grzymała-Busse 2007, 100), while the Public Service Act, mandating merit-based recruitment in the civil service, came only in 1996 (Kasemets 2012, 37). Until then, the integrity of the civil service depended in large part on the rectitude of its political masters. What is more, the youthful agents who the Security Police hired lacked the expertise needed to investigate complex corruption cases; they would acquire it only with time and experience (author's interview with Sinisalu, 7 November 2008).

Fortunately for Estonia, its leaders had already established a precedent of recruiting civil servants on merit even before independence. But once again, this was a case of actors taking the initiative to etch new rules and norms onto a *tabula rasa*. 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” (Randma 2001, 42). That author specifically cited the persistently low level of professionalism in the bureaucracy.

Sinisalu 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” (author's interview with Sinisalu, 7 November 2008). Specialized law-enforcement organs needed to deal effectively with such crimes did not yet exist. The creation of an independent State Audit Office had to wait until 1995. The Financial Supervision Authority, although established in 1993, did not become free from political control by the Finance Ministry until 1997 (Grzymała-Busse 2007, 100). A Commercial Code requiring adherence to Western accounting standards was not adopted until 1995 (Nørgaard and Johannsen 1999, 137-43).

This state of affairs differed from that found in some East European countries. In Poland, for example, agencies of monitoring and oversight already existed at the time of the communist regime's demise. The Supreme Audit Chamber (NIK) was established in 1977, the Ombudsman in 1987, and the Supreme Administrative Court (the court that hears citizen complaints about official malfeasance) in 1980. To be sure, they would acquire teeth only after communism fell (Grzymała-Busse 2007, 103). But at least they existed prior to the demise of the old regime. In Estonia they did not.

The consensus among the civil servants and other legal professionals whom one of the authors interviewed is that the enforcement capacity of Estonia's state agencies really began to improve around 1998 and 1999. By that time, salaries had increased substantially. In the courts, a provision was adopted granting judges life tenure with a retirement program, drawing many younger candidates into the profession (author's interview with Helve Särgava, 6 November 2008).

In sum, Estonia's reformers started early in building state agencies capable of economic administration. Most of the reformers themselves were very young and lacked any substantial experience in government, business, or academia. Many state agencies had no Soviet-era precursors, and it took the better part of a decade to produce a bureaucratic infrastructure that would be equal to the task of implementing and monitoring Estonia's new economic institutions, meaning the new rules that would govern the economy. The reforms created new state agencies where none existed before, got rid of old personnel who might have served as patrons to political capitalists, and established a pattern of meritocratic recruitment for civil servants. The policies thereby endowed Estonia with the state capacity necessary to make the new rules work.

It bears reiteration that the building of bureaucracy, and changes in personnel in the state agencies responsible for implementing economic policy, were not sufficient conditions for the emergence of robust economic institutions. The new state agencies may have been staffed by young idealists who were committed to serious institutional reform, but if the experience of the postcommunist region shows anything, it is that young idealists can readily be corrupted. The key was to ensure that the economic predators with a vital interest in corrupting them remained on the sidelines. Had the Laar government not steadfastly stuck to its policy of HBCs, a new class of political capitalists could have arisen to place their allies back into state positions. This is precisely what happened in so many other postcommunist countries and helps explain why property rights institutions remain weak throughout the region.

Thus, while the sturdy new state agencies provided vehicles for the effective administration of the new rules, the government's early policy of HBCs created an economic sphere in which entrepreneurs rather than political capitalists predominated, thereby enabling Estonia's rulers to fashion new rules without being corrupted and derailed by rent-seeking predators. The reformers' commitments to implementing HBCs and building a useable bureaucracy enabled Estonia to emerge during the late 1990s and in the current century as the postcommunist leader in terms of the quality and effectiveness of its economic institutions. Indeed, even though Estonia's institutions were weak and unstable at the time of their nascence, over time they have become remarkably efficient and authoritative.

### **The Outcome: Robust Property Rights Institutions and Low Corruption**

Estonia is indeed exceptional in the postcommunist region, where SBCs produced a class of political capitalists who have systematically undermined efforts to build market-supporting institutions, particularly in the sphere of property rights. In Estonia the comparative paucity of political capitalists not only allowed effective property rights institutions to take root; it also cleared the way for steady improvements in the integrity of these institutions over time.

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, the top anti-corruption specialist at the Ministry of Justice, put it. It was filled with vague provisions and loopholes, and the law’s definition of who is and is not considered a public official was excessively restrictive, limiting the range of officials subject to requirements on conflicts-of-interest and asset-declaration (interviews with Sööt, 5 September 2008 and 4 April 2014).

To solve these problems, in 2008 the Justice Ministry adopted a strict new Anti-Corruption Strategy. The effort culminated in the passage of key amendments to the Anti-Corruption Act in 2012 to correct its previous shortcomings. 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 (author’s interview with Sööt, 4 April 2014).

Another flaw in the old law was that it gave the Justice Ministry sole responsibility for supervising enforcement; other state agencies had no obligation to ensure their employees’ compliance. Says Sööt: “The aim of the new law is to decentralize 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” (author’s interview with Sööt, 4 April 2014).

In 2013 the Justice Ministry issued a new Anti-Corruption Strategy that improves upon the 2008 version. Most notably, it has shifted the 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” (author’s interview with Sööt, 4 April 2014).

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 thoroughly criminalized neighbor, Estonia faces higher money-laundering risks than the average EU member. Yet, unlike Latvia and Cyprus, which face similar circumstances, Estonia has not turned into a hub for illicit Russian capital.

Why not? The answer lies in the institutions and their enforcement, which themselves arose thanks to the early policies of Estonian governments. The Financial Action Task Force (FATF) is an international body devoted in part to fighting money laundering and the financing of terrorist networks. It is made up largely of the advanced industrialized countries and does not include Estonia. But Estonia has taken measures to adhere to FATF standards and has received positive evaluations for its efforts from international bodies (MONEYVAL 2014). “We are currently evaluating our resources and capacity for investigation,” says Veronika Mets, the senior AML specialist at the Ministry of Finance. She notes:

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 [as they are], 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. “This rule has been criticized by firms that want to do business here,” Mets notes, “but we believe we need additional safeguards” (author's interview with Mets, 14 May 2014).

Contrast Estonia with Latvia, which has become a hotbed for dirty money from Russia. In early 2014, JP Morgan shut down its money-clearing services in Latvia after complaints from U.S. regulators and Global Witness, the non-governmental watchdog (*Bloomberg*, 2 January 2014).

Estonia's strides in AML law reveal just how far state-building has come. Estonian institutions have become strong enough to withstand pressure from banks and foreign political capitalists who might wish to turn the country into an offshore haven. In Latvia, by contrast, AML institutions are largely compliant with international standards on paper but remain unenforced in practice (Bowen and Galeotti 2014).

Other examples abound of Estonian lawmakers strengthening laws and regulations as weaknesses become apparent. Passed in 2000, the Public Information Act (available in English on the *State Gazette [Riigi Teataja]* website) gives citizens wide access to official documentation and established a powerful Data Protection Inspectorate to enforce the law. In 2012, parliament adopted a new Civil Service Act (also available on the *State Gazette* website) that requires all vacant posts in the state administration to be filled through open competition. Competition must be fair regardless of whether it is open to the public or conducted internally, and the announcement of a competition must be distributed widely. The law applies not only to new appointments but also to promotions. Transparency prevails in public procurement as well. All notices for public tenders are published online in the State Public Procurement Registry (SPPR), preventing

the kinds of corrupt practices common in other postcommunist countries (Kasemets 2012, 27).

The transparency of official documentation provides a boon to investigative journalists, whose access to information further enhances official rectitude. Mihkel Kärmas, a leading Estonian muckraker, credits the Public Information Act with helping him break many stories. Among these was an exposé on local officials in the province of Pärnu who forged 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 (author's interview with Kärmas, 22 October 2008).

The fact that Estonian institutions encourage transparency is surely a good thing. But good institutions were an outcome, rather than the original cause, of a business environment in which political capitalists were and remain marginalized. The rules matter now; they influence economic and political behavior. But they never would have emerged and become durable and effective in the first place had the Estonian government not previously imposed HBCs in the early and mid-1990s. That policy fashioned an economic arena comparably free of economic predators and a political elite that was subject to relatively little pressure from such predators.

Estonia's economic institutions are far from perfect, and the country is certainly not corruption-free. Problems remain in regulating the financing of political parties, among other areas (Sikk and Kangur 2008). Compared with other postcommunist countries as well as many other countries at its level of income, however, Estonia is a standout. In Transparency International's Corruption Perceptions Index (available online), which measures and ranks countries according to the probity of their public sectors, Estonia consistently occupies first place in the postcommunist region and scores respectably even by West European standards. In 2014, Estonia ranked 26<sup>th</sup> out of 175 countries in the world (in a tie with France). By comparison, the Czech Republic ranked 53<sup>rd</sup>, Armenia 94<sup>th</sup>, and Russia 136<sup>th</sup>.

### **Estonia in Comparative Perspective**

A comparison with other postcommunist countries brings the Estonian experience into sharp relief. Ukraine never saw the takeover of power by Estonian-style revolutionaries bent on subjecting business actors to HBCs. From the start, its political establishment was dominated by ex-communists. They were not about to abandon their allies in state enterprises by cutting them off from soft loans and subsidies. And SBCs proved quite profitable for the new business elite and their government cronies. Following the introduction of a new currency in 1992, the central bank unleashed tides of easy money into the economy. Preferential access to these funds went to the politically-connected. Enterprises set up pocket banks for the express purpose of obtaining soft financing from the central bank (Borish and Montes-Negret 1998, 103-10). Connected firms could also obtain cheap loans from state-owned banks (Landy 1997, 15-6).

In addition, political capitalists allied with president Leonid Kuchma (1994-2004) established companies that profited through one-sided transactions with state enterprises. By selling inputs dear and buying the resulting output cheap, they received lucrative subsidies from the state companies they controlled (*Financial Times*, 10 and 12

November 1999). The most notable example occurred at state gas monopoly Naftohaz Ukrainy. Businessmen such as Dmytro Firtash (allegedly linked to international criminal mastermind Semyon Mogilevich) reportedly reaped vast fortunes by buying Russian gas and selling it on to Naftohaz at higher prices, among other schemes (Global Witness, 2006; *Kyiv Post*, 10 May 2006).

Rigged privatizations at pennies on the dollar were another source of SBCs. In June 2004 a consortium led by oligarchs Rinat Akhmetov and Viktor Pinchuk paid \$800 million for steel giant Kryvorizhstal. Just over a year later, in perhaps the only honest large privatization in Ukrainian history, a new government reversed the previous sale and resold it to ArcelorMittal for six times as much (*Zerkalo nedeli*, 18 June 2004; *Kyiv Post*, 19 March 2010).

The wide availability of SBCs rocketed political capitalists to the top of the economic elite. An examination of all individuals who appeared on published lists of the top-20 richest Ukrainians from 2007 to 2012 (hereafter referred to as the “plutocrats”)<sup>2</sup> reveals that 83 to 98 percent allegedly gained their fortunes with the help of political connections (Table 3). This compares to 42-53 percent of Estonia’s plutocrats (Abrams 2014, 117-18).

#### INSERT TABLE 3

Since they thrive on rules that are weak, murky, and easily manipulated, political capitalists ensured that effective economic institutions would never develop in Ukraine. If property rights institutions are sound, they should be able to prevent *criminal corporate raiding*, or the illegal expropriation of private businesses (Table 4).<sup>3</sup> In Ukraine, 35-45 percent of plutocrats have allegedly engaged in at least one raid, compared to 5-11 percent in Estonia. Raiding is just as frequent among Ukraine’s *non-plutocratic elite*, or those who did not make the top-20 rankings. Non-plutocratic raiding can be measured by the number of economic sectors in which there has occurred at least one raid allegedly committed by a member of this stratum. The list of sectors comes from the standard United Nations classification, which divides a given economy into ten sectors (UN DESA 2008, 274). Of those, one<sup>4</sup> was excluded from this analysis due to high and varying concentrations of state ownership across countries. Of the nine remaining sectors, Abrams (2014, 62) found at least one non-plutocratic raid in seven sectors in Ukraine but only two sectors in Estonia. That raiding is highly prevalent in Ukraine is confirmed by other scholars (Markus 2015, 47-85) and leads to the unavoidable conclusion that its property rights institutions have failed.

#### INSERT TABLE 4

The fact that political capitalists have captured Ukraine’s state institutions would not exactly shock most specialists. But they might be surprised to find that a similar situation prevails in Poland. Western academics have consistently hailed Poland as the postcommunist exemplar in forging sturdy, well-enforced property rights institutions (Glaeser, Johnson, and Shleifer 2001; Woodruff 2004; Easter 2012).

The reality is far different, as evidenced by the pervasiveness of criminal corporate raiding. At only 13-15 percent of plutocrats, alleged raiders in this cohort are

far rarer than they are among Ukraine's plutocrats. Yet both countries have seen *non-plutocratic* raiding in seven of nine sectors, compared to two in Estonia (Table 4). Even this figure obscures the true scale of the problem. Pawel Rey and Lech Jeziorny were business partners who found themselves illegally jailed and had their business bankrupted by the authorities. They went on to establish an NGO that has uncovered over 2000 cases similar to theirs (*Financial Times*, 8 March 2010; JohnFeffer.com, 22 January 2015 [accessed 23 April 2015]). Despite claims to the contrary by Western specialists (Woodruff 2004; Easter 2012), illegal shareholders meetings and the bankrupting of takeover targets through false prosecutions and back-tax claims are commonplace in Poland (Abrams 2014, 307-35).

What may confuse specialists about Polish capitalism is its respectable-looking veneer. In contrast to Ukraine, state agencies like the Supreme Administrative Court and the Financial Supervision Authority operate with a reasonable degree of professionalism. Nevertheless, the sheer number of raids, particularly among the non-plutocratic elite, belies the notion that property rights are secure. The fact that certain state agencies are professional does not mean that they are effective. A handful of honest state bodies are left to pick up the pieces in an environment where corrupt businesspeople regularly conspire with prosecutors, police, tax officials, intelligence agents, and judges to expropriate businesses (Abrams 2014, 307-35). In Estonia, would-be raiders run up against a wall of incorruptible judges and civil servants whose help would be essential either to let the raid happen or make it happen. When interviewed, Estonian officials depict a state administration that is virtually impervious to such corruption (Abrams 2014, 421-33).

The reason behind Poland's failed property rights institutions was the plentiful availability of SBCs, particularly in the 1990s. By late 1991, a coalition of anti-communists had assumed full control of the government. But similarities with Estonia stop there. Although successive Polish governments went further than Ukraine in implementing HBCs, they did not go nearly as far as their Estonian counterparts did (see tables 1&2). When it comes to HBCs, a country either takes the full course or does not—and Poland did not. The upshot would be an economic environment littered with political capitalists.

The siphoning of state assets by the *nomenklatura* began in the 1980s (Staniszki 1990) but expanded dramatically after communism fell. Non-performing loans to corrupt businesspeople linked to the communist-era establishment (*Życie*, 30 April-1 May 1997; *Gazeta Bankowa*, 29 November 2012) reached near-crisis levels by the mid-1990s (Table 2). Scores of prominent political capitalists such as billionaire Zygmunt Solorz (*Nasz Dziennik*, 18 May 2013) allegedly launched their careers thanks to soft loans from the Fund for Foreign Debt Servicing (FOZZ). Michał Falzmann, one of two investigators who died in suspicious circumstances while investigating the matter, claimed to have found \$3.5 billion in illegal transfers from the FOZZ to foreign bank accounts. The response by regulators, particularly Finance Minister Leszek Balcerowicz, was half-hearted at best (Łoś and Zybertowicz 2000, 167-75). Also fueling the rise of political capitalists was a multibillion dollar tax evasion scam in the import of heating oil along with questionable contracts doled out by oil company PKN Orlen (*Wprost*, 35/2004 and 39/2005; author's interview with Witold Gadowski, 21 April 2008). On top of it all, many large firms were able to negotiate special tax exemptions (Schoenman 2005).

The formal privatization process stood out for its relative honesty. Of the ten largest privatizations,<sup>5</sup> only three showed indications of malfeasance, compared to eight in Ukraine, and none of the three Polish sales amounted to blatantly underpriced giveaways. This explains why political capitalists have a lower presence among Poland's plutocratic elite than they do in Ukraine (Abrams 2014, 146-51, 289-94).

But the non-plutocratic elite is marked by deeply entrenched networks of rent-seeking business actors who thrived from freely available SBCs and used their resulting riches to corrupt the political establishment. Measuring the proportion of non-plutocratic political capitalists is difficult. But the high frequency of criminal corporate raiding provides a clue. Because political connections are essential to raiders, raids tend exclusively to be the work of political capitalists, not entrepreneurs. So it is inconceivable that a country with Poland's level of non-plutocratic raiding *lacks* a well-established class of non-plutocratic political capitalists.

It is worth remembering that Poland is a consolidated democracy with a vigorous independent media and free elections that routinely unseat incumbents. But the problem of endemic criminal corporate raiding cannot be cured merely by "kicking the bums out" at the next election. Even if the new government purges some state agencies, personnel in other bodies such as the police, the intelligence services, and the judicial system cannot easily be replaced. Whether due to legal constraints or practical difficulties in finding replacements, judges, prosecutors, police, and intelligence agents often stay on from administration to administration.

Consequently, influential business actors often maintain contacts in key state bodies even after a change of government. To the extent that their allies in other agencies get dismissed, political capitalists can often forge new links with the replacements. It would be one thing if there had occurred the kind of systematic vetting process seen in Estonia, which filtered out officials who were politically compromised, corrupt, or incompetent. But in Poland (not to mention Ukraine), efforts to this end proved woefully inadequate. As a result, many personnel linked to the former regime continued to serve—and to provide points of contact for political capitalists—throughout the judicial system, police, and intelligence services (Łoś and Zybortowicz 2000, 111-36). Notably, these are precisely the agencies that are most important to aiding the execution of criminal corporate raids. Contrary to widespread belief, then, democracy alone is inadequate for preventing economic criminals from hijacking the state and expropriating private property.

In Estonia, the relative weakness of political capitalists opened the door for governments to build and continually enhance property rights institutions. Poland and Ukraine display the opposite dynamic; corrupt business actors have consistently obstructed institutional changes that might render property rights more secure. In both countries, even those governments with the firmest anti-corruption commitments ended up foundering under corrupt enticements from political capitalists—something that might have been avoided with the early and comprehensive implementation of HBCs and personnel changes. Among these were Poland's sanctimonious Law and Justice coalition (2005-07) and Ukraine's Orange coalition (2004-05, 2007-10) and post-Maidan governments (2014-present) (*Polish News Bulletin*, 21 September 2007; *Ukrainian Weekly*, 10 April 2015; Wilson 2014, 44-8).

In Ukraine, anti-corruption law has proved a fig leaf while the judiciary remains notoriously crooked. This circumstance is due in no small measure to powerful business interests who wish to keep things that way. Judicial reforms passed in 2013 introduced some basic limits on the arbitrary powers of prosecutors but did not touch the critical issues of unprofessionalism and lack of independence on the part of judges. In 2012, the Group of States Against Corruption (GRECO) issued Ukraine a list of 13 recommendations for reducing corruption; by 2014 it found satisfactory progress on a mere two of its proposals (as reported by Freedom House in *Nations in Transit 2014*, available on its website). Personnel rules inhibit the dismissal of corrupt officials (*The Guardian*, 6 February 2015). To make matters worse, honest law-enforcers find themselves on the receiving end of manufactured criminal cases and are often killed (*Ukrainian News*, 12 October 2006; *Kyiv Post*, 14 September 2006).

In Poland, too, political capitalists and their official patrons have frequently obstructed institutional reforms. The current Civic Platform government even resorted to unconstitutional measures to prevent enhancements in public-information access (Freedom House, *Nations in Transit 2013* [available online]). Additionally, GRECO (2014) deemed Poland delinquent in fulfilling its anti-corruption commitments, with genuine progress made on only three of 16 issues. A 1999 World Bank study caused a storm for its findings of malfeasance, delays, and understaffing in the judicial system. But the report spurred no meaningful change, and in recent reports, Freedom House has noted the same problems (*Nations in Transit 2011, 2013* [available online]). Arbitrary arrests and detentions without trial remain all too common (Freedom House, *Nations in Transit 2014*). Meanwhile, Estonia has developed one of the most transparent state administrations in the world.

Even if Poland may have less overall corruption than Ukraine, political capitalists in both countries can exploit official connections as needed to evade, undermine, or manipulate the rules. On this score, Poland and Ukraine both fall far behind Estonia. This state of affairs is due to the failure of successive governments in both Poland and Ukraine completely to cut off political capitalists from SBCs and implement personnel and organizational policies that would undermine their ability to exploit connections in the state apparatus.

### **Implications For Theory and Policy**

Our analysis opens the possibility of transcending the interminable, inconclusive debate over whether liberal market policies or sound institutions are more important for countries in economic transition. Liberals (or as they are frequently called when being reviled, neoliberals) focus on policies, and particularly on price liberalization, monetary and fiscal stabilization, privatization, deregulation, and debt-reduction. Institutionalists insist upon laws that ensure an impartial judicial system, capital-market rules, regulations that increase transparency, insurance schemes, and workable frameworks governing relations between the representatives of labor and capital.

Like the liberals, we claim that policies are crucial and can have good effects even in the absence of sound institutions. Like the institutionalists, we acknowledge and laud the effects of well-designed rules.

Unlike many liberals, however, we regard a single aspect of liberalization—namely, the imposition of HBCs—as key. HBCs mean liberalizing prices and abolishing subsidies, soft financing, and tax breaks not justified by economic rationality. But they do not necessarily involve other aspects of liberalization often touted as paramount, such as privatization and debt-reduction; nor do we believe such measures are necessary to produce good institutions.

Unlike the institutionalists, we find that institutions are auspicious by-products rather than prime movers in economic transformation. We also argue that efforts to revise the rules will founder or ultimately produce Potemkin institutions if predatory interests with a stake in undermining the institutions dominate the economic arena. The institutions that most impinge upon the ability of political capitalists to ply their felonious trade—anti-corruption laws, judicial independence, and legally protected property rights—will remain especially underdeveloped.

In addition to HBCs, the personnel and organizational policies of Estonian governments were also important. But they never would have produced the effects they did had HBCs not fatally weakened the political capitalists interested in undermining sound institutions.

Our findings also shed light on why some countries have more effective institutions than others. Nineteenth-century biologist Jean-Baptiste Lamarck famously argued that giraffes developed longer necks simply by making a concerted effort to reach the trees. Like Lamarck, the standard institutionalist prescription, to “build institutions,” tends to assume that governments can put their countries on a course toward institutional development by force of will alone. According to this Lamarckian view, improvements in institutional “traits” arise and become effective once leaders have made the choice to bring them about. Institutionalists tend to ignore the need to drive out the status-quo forces that act as a break on meaningful change.

Our own approach is more Darwinian. We find that building robust institutions requires the marginalization of certain “species”—namely, political capitalists—whose interests are opposed to establishing authoritative, impersonal legal rules. And the way to weaken such opponents is to take away the SBCs they rely on for sustenance. Time and again in the postcommunist region, we have seen how powerful networks of political capitalists manipulate and sabotage institution-building efforts. In Estonia, to a greater extent than elsewhere in the region, HBCs were adopted, sidelining budding criminal networks and rendering efforts to install effective property rights institutions viable.

If our conclusions are correct, efforts to build market-supporting institutions without first undermining political capitalists will fail to have their desired effects even if they are adopted. Consider the implementation of better protections for minority shareholders, a measure frequently proposed by institutionalists to prevent abuses in the sphere of corporate governance. In certain respects, Ukraine has enacted stringent guarantees on the rights of minority shareholders. But far from improving the situation, the rules only serve to grant powerful political capitalists leverage to buy up minority shareholdings in targeted firms as a prelude to expropriating them from majority owners (*The Ukrainian Observer*, November 2006). When the economic sphere is under the sway of political capitalists, calls to “build institutions” will very likely fall on deaf ears, or they will “succeed” but produce rules that are twisted to conform to the interests of corrupt business actors.

Indeed, institutions can be good things, but they can also be devoid of content. A recent study of transparency in corporate information placed Albania, Bosnia-Herzegovina, Kyrgyzstan, and Russia ahead of the United States (Arachnys 2014). This ranking may well provide an accurate assessment of the outward appearance of formal rules. It may reflect the ostensibly sound legal advice that Western advisers gave governments and those governments' efforts to create the impression that they took the advice seriously. This example shows, however, how vacuous formal rules can be in environments where political capitalists rule economic life, as they do in all four of the countries mentioned above.

Rather than trying to establish all manner of economic institutions, reformist governments in early-capitalist societies may get more bang for their buck by focusing on weakening predatory business actors. Imposing hard budgets is an efficient way to do so and is far more feasible than trying to install a complete set of market-supporting institutions. Joseph Stiglitz famously attacked Russia's economic reformers under Boris Yeltsin, along with their IMF advisers, for ignoring the need to build market-supporting 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 ill-gotten wealth abroad (Stiglitz 2002, 133-65). But Stiglitz has the causal arrows reversed. The rise of economic predators from the early 1990s onward is precisely what hampered Russia's institutional development in the first place. Political capitalists whose fortunes were made on access to state subsidies, soft financing, tax breaks, and other privileges provided by the state were ascendant well before the notorious loans-for-shares privatizations that created the so-called oligarchs. The tradition continues in Putin-era Russia. While Vladimir Putin has pulled down most of Yeltsin's favorites and created his own oligarchy, access to cheap capital from the state and myriad other favors doled out by rulers remains the way that Russia's wealthiest businesspeople attain their riches and maintain their control over the economy. Is it any wonder, despite many years of blustery rhetoric about the need for the rule of law in the economy, that market-supporting institutions remain a mirage in Russia?

Indeed, Stiglitz's contention—or, rather, assumption—that sound institutions had a chance of taking root under the conditions Russia faced during the Yeltsin era, or for that matter even today, is hopelessly romantic. Installing an effective property rights regime involves the enactment of a complex array of rules as well as the construction of a broad range of state agencies capable of enforcing those rules. Such rules will not be adopted or will fail even if adopted as long as the economy remains dominated by capitalists whose fortunes depend on political favor rather than business acumen.

Governments in early-capitalist countries can obtain far greater leverage over the problem by imposing HBCs. 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. HBCs not only weaken private political capitalists; they also undermine official political capitalists, or state officials in business for themselves. These elites, along with corrupt low-level bureaucrats, exploit overly burdensome regulatory restrictions to predate upon property owners, a problem that is rampant in many postcommunist countries (Markus 2015). Removing such

restrictions is a key component of instituting HBCs and promises to undercut the ability of state actors to attack firms. Nevertheless, as Markus notes (69-71), deregulation can meet fierce and often successful resistance from the very state agents charged with implementing the policy. Further investigation is required to assess the conditions under which such resistance succeeds or fails.

The findings presented here may enjoy broad applicability. In criminalized economies around the world, SBCs can be seen at work creating and sustaining classes of predators. From Mexico and Venezuela to the Philippines, from much of the Middle East to broad swathes of Africa, 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 key business actors (Henry 2003; van de Walle 2001). Similarly, in early-modern Europe, SBCs were instrumental in establishing 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 accumulation. Rather, presaging modern-style state subsidies, rulers bestowed land upon clients, who passed it down by inheritance thereafter.

An important question is whether the implementation of HBCs becomes more difficult as political capitalists grow wealthier and more entrenched. This article highlights only one case in which HBCs were imposed. While some wealthy and influential business actors already existed by that point, they had not been around long enough to solidify their positions before Pro Patria launched its economic reforms. In countries such as Poland and Ukraine today, by contrast, powerful economic criminals are extremely well rooted and arguably in a better position to resist government efforts to harden budgets. In these countries, 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 political capitalists or another. Each government thus begins its tenure at a major disadvantage from the standpoint of implementing real reform. Furthermore, even those business actors who temporarily lose influence in national policymaking due to a change in government still have cronies representing their interests in key positions in the state administration, particularly the courts, police, and intelligence services. If not, they can often cultivate links with the new leadership. This situation can complicate efforts to enforce HBCs and punish those who aid and abet the provision of illegal SBCs. What is more, many political capitalists 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 state largesse may not weaken them as much as it once would have. Unfortunately, the evidence from our investigation does not allow a systematic inquiry into the impact of varying degrees of criminal entrenchment on the prospects and effectiveness of HBCs.

Still, in almost all cases, SBCs continue to play a key role for corrupt business actors and their evolving fortunes. Governments could readily clip their wings by taking away the easy access to state resources they currently enjoy. In Ukraine, tax breaks, selectively-granted subsidies, and cronyist financing from pocket banks as well as fraudulent public procurement tenders continue to bolster influential business groups. A similar situation prevails in Poland though without the pocket banks, as much of the country's banking industry is now under foreign ownership. To be sure, political capitalists possess substantial resources to survive a reasonably long winter of HBCs and

honest governance. But a reformist administration could very well tilt the balance against political capitalists and in favor of entrepreneurs. At this late stage, it may require a prolonged, gradual process to marginalize the defenders of the status quo. But nobody ever said it would be easy. In an early-capitalist context, HBCs may be the best hope for getting the job done. They certainly stand a better chance than do institutionalists' dreams of transplanting Scandinavian-quality institutions into the likes of Russia and Ukraine.

To be sure, the outcome—the marginalization of political capitalists—might only occur gradually. But the policies must be implemented rapidly. For governments seeking to harden budget constraints, speed is of the essence. Stiglitz and likeminded scholars have consistently argued for gradual reform (Stiglitz 2002, 53-88, 133-65). Whether or not gradual reform is optimal for ensuring long-term economic growth is beyond the scope of this investigation. When it comes to laying a foundation for sound property rights, however, 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 (Stiglitz 2002, 133-65). 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 most respects, and the economy's crash had much more to do with the final, agonizing unraveling of the Stalinist economic model than with precipitous reforms taken in the early 1990s. And while the early post-Soviet Russian state simply lacked the resources to continue subsidizing inefficient enterprises at Soviet-era levels, it certainly did not impose HBCs. To this day, Russian firms remain propped up by myriad SBCs including tax breaks, cheap energy supplies from Gazprom, fraudulent public tenders, and other privileges (Stratfor, 9 April 2012; BIORRES, 11 July 2011; *The Moscow Times*, 28 January 2014). In this regard, Russian reform *was* gradual. For a case of actual shock therapy, one need look no further than Estonia. If the experiences of Poland and Ukraine show anything, it is that reformist governments that are not sufficiently quick to harden budget constraints will likely founder under pressure from corrupt status-quo interests as support from their key constituencies begins to wane. HBCs certainly have a better chance of transforming economies if they are implemented as comprehensively and swiftly as possible.

In any event, institution-building takes time and can only be done, if it is done at all, relatively gradually. Policy change can be implemented speedily if the political will is there to do it, and may be a prerequisite for authentic, lasting institutional transformation.

International organizations and lenders such as the European Union, OECD, IMF, and World Bank can play an important role. They might aid reformers in early-capitalist societies by shifting away from recommending myriad changes, from privatization to adopting rules that enhance corporate transparency to restructuring the judicial system, and instead focus on counseling the adoption of HBCs. Indeed, the Estonian case suggests that HBCs can create an environment in which the construction of effective property rights institutions can proceed. Starting with a meager institutional endowment, successive Estonian governments have built an impressive set of property rights institutions and have continually improved them over time. Estonia's institutional achievements depended vitally on the adoption, early in the transition, of policies that tilted the business and political environments against the kind of political capitalism that has typically emerged elsewhere in the postcommunist world.



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**Table 1. The Degree with which Hard Budget Constraints were Instituted by Second Year of Transition (scale: 1.00-4.33)**

<b>Country</b>	<b>Enterprise Restructuring</b>	<b>Price liberalization</b>	<b>Banking Reform</b>	<b>Average</b>	<b>% Difference from Estonia</b>
Estonia (1993)	3.00	4.33	3.00	3.44	
Hungary (1991)	2.00	4.33	2.00	2.78	-20.0%
Latvia (1993)	2.00	4.33	2.00	2.78	-20.0%
Slovakia (1991)	2.00	4.00	2.00	2.67	-23.3%
Czech Republic (1991)	2.00	4.00	2.00	2.67	-23.3%
Lithuania (1993)	2.00	4.00	2.00	2.67	-23.3%
Poland (1991)	2.00	3.67	2.00	2.56	-26.6%
Bulgaria (1992)	1.00	4.33	1.67	2.33	-33.3%
Moldova (1993)	1.00	3.67	2.00	2.22	-36.6%
Slovenia (1992)	1.00	3.67	2.00	2.22	-36.6%
Croatia (1992)	1.00	4.00	1.00	2.00	-43.3%
Macedonia (1992)	1.00	4.00	1.00	2.00	-43.3%
Armenia (1993)	1.00	3.67	1.00	1.89	-46.6%
Azerbaijan (1993)	1.00	3.67	1.00	1.89	-46.6%
Georgia (1993)	1.00	3.67	1.00	1.89	-46.6%
Kyrgyzstan (1993)	1.00	3.67	1.00	1.89	-46.6%
Russia (1993)	1.00	3.67	1.00	1.89	-46.6%
Serbia (1992)	1.00	3.67	1.00	1.89	-46.6%
Albania (1992)	1.00	2.67	1.00	1.56	-56.7%
Kazakhstan (1993)	1.00	2.67	1.00	1.56	-56.7%
Romania (1991)	1.00	2.67	1.00	1.56	-56.7%
Uzbekistan (1993)	1.00	2.67	1.00	1.56	-56.7%
Belarus (1993)	1.00	2.33	1.00	1.44	-60.1%
Mongolia (1991)	1.00	2.33	1.00	1.44	-60.1%
Tajikistan (1993)	1.00	2.33	1.00	1.44	-60.1%
Ukraine (1993)	1.00	1.00	1.00	1.00	-73.4%
Bosnia-Herz. (1993)	1.00	1.00	1.00	1.00	-73.4%
Turkmenistan (1993)	1.00	1.00	1.00	1.00	-73.4%

Source: EBRD Transition Indicators (available on EBRD website)

**Table 2. Non-Performing Loans as a Percentage of All Loans, 1991-2000**

Country	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	1990s 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
Russia					12.3	13.4	12.1	30.9	28.1	16.1	18.8
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-Herz.									58.7	13.9	36.3
Albania					34.9	40.1	91.3	35.4	32.7	42.6	46.2
Macedonia						66.1	59.5	50.3	62.6	46.5	57.0

\*NPL levels reflect latest available data. In some cases, data was not reported in the latest EBRD report; figures instead come from the most recently available report in which data was actually provided.

Sources: EBRD (1998-2005). Certain data not provided by EBRD, including 1993 data for Estonia and the Czech Republic, comes from Scholtens (2000).

**Table 3. Political Capitalists Among the Plutocratic Elite**

<b>Country</b>	<b>Percentage*</b>
Estonia	42.1% to 52.6%
Poland	56.4% to 69.2%
Slovakia	76.5% to 88.2%
Ukraine	82.5% to 97.5%

*\*Represents the percentage of the plutocratic elite comprised of political capitalists*

*Source: Abrams (2014, 118)*

**Table 4. Criminal Corporate Raiding**

<b>Country</b>	<b><u>The Plutocratic Elite</u></b>		
	<b># of Alleged Raiders</b>	<b>Total # of Plutocrats</b>	<b>Alleged Raiders - %</b>
Estonia	2 to 4	38	5.3% to 10.5%
Poland	5 to 6	39	12.8% to 15.4%
Ukraine	14 to 18	40	35.0% to 45.0%

<b>Country</b>	<b><u>The Non-Plutocratic Elite</u></b>
	<b># of Sectors With One Raid (max = 9)*</b>
Estonia	2
Poland	7
Ukraine	7

*\*Represents the number of economic sectors in which there has occurred at least one raid*

*Source: Abrams (2014, 61-62)*

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<sup>1</sup> All interviews for this article were conducted by Abrams.

<sup>2</sup> The 2008 rankings had to be excluded from the analysis since they were not available for some of the countries under consideration.

<sup>3</sup> The term “criminal corporate raiding” first appeared in Firestone (2008).

<sup>4</sup> The sector that was excluded was “public administration and defence, education, human health and social work activities.”

<sup>5</sup> The rankings of the ten largest privatizations were compiled by multiplying a company’s revenues the year prior to the privatization by the percentage sold.