

# Slovo

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## Editorial Statement

*Slowo* is a fully refereed journal, edited and managed by postgraduates of the School of Slavonic and East European Studies, University College London. This journal aims to discuss and interpret Russian, Eurasian, Central and East European affairs, covering the fields of anthropology, art, economics, film, history, international studies, linguistics, literature, media, philosophy, politics and sociology.

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Corruption Networks in the Russian Economy<sup>1</sup>

HEIKO PLEINES

**ABSTRACT** Enterprise directors in the planned economy developed close networks with bureaucrats and politicians, mainly in the branch ministries, in order to obtain the means of production needed by their enterprise. Many members also used these networks for embezzlements. Since the collapse of the Soviet Union, the networks have adapted to the changes, by increasing attention to the role of money and by including new members. However, they still offer enterprise directors privileged access to state resources. Rent-seeking, therefore, can be seen as a central activity of corruption networks in the post-Soviet economy. The nature of such networks is examined more closely in case studies of the Russian banking sector, the coal industry and the oil industry.

*Two Sets of Rules*

THE FOLLOWING ANALYSIS is based on the simplified assumption that there are often contradicting sets of rules governing business behaviour in post-Soviet economies. The first set of rules is based on official legislation. The second set of rules is of an informal nature. It can either supplement the official rules, like the rules of etiquette do or represent an alternative set of rules. If these alternative rules are widely accepted within a society, illicit practices are common and normally do not provoke a strong feeling of guilt. Those involved feel legitimized by the alternative rules and their excuse refers to this fact, claiming that 'everybody does it'.

Such an alternative set of rules exists in all societies that have developed a codified official set of rules. The regulation of copyrights can serve as an example of alternative rules in the economic sphere of industrialized Western societies. Whereas the official rules, in the form of laws on copyright, heavily restrict the reproduction of computer software, sound carriers and printed publications, it is common practice to provide friends with *de jure* illegal copies. The alternative rule states that as long as reproduction is done on a small scale and not for profit, i.e. for friends only, copyright regulations do not matter. Another official rule which is rivalled by an alternative rule is the antitrust law. It seems that many companies on oligopolistic markets have

replaced the rules of the antitrust law with an alternative set of rules based on price agreements and division of markets. Many rules of the tax laws are also weakened by a general alternative rule allowing one 'to cheat a bit' when dealing with the tax authorities.

This means the relevant question concerning the alternative set of rules is, first of all, of a quantitative nature, asking in which spheres we find alternative rules and how widely they are accepted. The gradual differences in the acceptance rate of alternative rules can roughly be divided into three categories. If alternative rules are accepted only by single individuals, these individuals are isolated as criminals and punishment is generally accepted. If alternative rules are accepted by a larger group within society, it becomes more difficult to treat all members of the group as criminals. In fact, such a group might succeed in initiating a discussion on the relevant official rules leading in some cases to tolerance of their behaviour or even to a change in the official rules. The consumption of narcotics falls into this category in many Western societies. Radical protest forms, like blocking trafficways or occupying buildings are another example. Environmental groups, especially, have increased their popularity with the help of such methods, though they often lead to court trials. Finally, there are cases, like the copyright law, where the large majority of society accepts the alternative rules.

The quantitative question of spheres and areas of acceptance has consequences for the quality of alternative rules as well. An important point is that the acceptance rate of the alternative rules is directly related to self-assertion of the official rules. The higher the acceptance rate of alternative rules, the more difficult it is to disclose and sanction violations of the relevant official rules. In extreme cases, for example, tacit acceptance from the side of law enforcement and judicial organs, the alternative rules can gain quasi-official character. In Russia, this extreme seems by and large to be realized in the case of corruption.

*Corruption in the Russian Economy*

Corruption can generally be defined as the misuse of public power and/or public resources for personal gains. This definition, though, needs specification. In a narrow interpretation, corruption is directly linked to the payment of bribe money to a state official in return for a concrete favour. Yet critics argue that such a definition is short of showing the full phenomenon. They prefer a wider definition, according to which corruption includes networks between state officials and entrepreneurs or directors of Soviet enterprises. These networks are not necessarily based on direct transactions (bribe payment against favours) but on mutual trust, on the knowledge that doing a favour will offer the right to

<sup>1</sup> This text is based on research financed by the Volkswagen Foundation as part of the project on 'Economic elites in Russia' at the Federal Institute for Russian, East European and International Studies (BIOst), Cologne. Further information about the project can be found on the internet at: [http://www.bioست.de/Projekt\\_VW-WER/wershort.htm](http://www.bioست.de/Projekt_VW-WER/wershort.htm)



demand a favour in return.<sup>2</sup>

Particularly in this wider sense, corruption is essential for understanding the Soviet economy. The Soviet system promoted corruption and could probably only function through it. Due to political repression and the command economy, the Soviet system was very inflexible and was unable to react to political dissatisfaction or economic needs of the population with adequate adjustment mechanisms. An obvious consequence of this inflexibility was widespread corruption that was employed to weaken the state's control and to allow for more flexible action.

Soviet managers had to break the law in order to obtain supplies they needed to meet the quota plan. Normally, managers were only punished for under-fulfilment of the plan, not for legal violations. Therefore, 'it seems a fair generalization that all Soviet managers are, ipso facto, criminals according to Soviet law'.<sup>3</sup> Moreover, in order to avoid punishment and to get preferential treatment from relevant authorities, managers were tempted to give false reports about their performance.

Nevertheless, it was the longing for personal advantages as well that led the rulers of the Soviet economy into criminal activities. In an economy where nearly everything was scarce, virtually every manager could make substantial profits through embezzlement. In such a system, managers needed unofficial connections with other managers and with influential party officials in order to make deals and to feel secure afterwards.<sup>4</sup>

After the end of the Soviet Union the situation in Russia has changed considerably. In the wake of economic reforms, corruption spread to the privatization process and to the partially-liberalized foreign trade regime. Furthermore, the transition to a money economy changed the nature of corruption. Under socialism power and influence were the most important criteria, which subsequently ensured personal wealth as well. In post-socialist Russia, personal wealth has become a central value and a career in state

<sup>2</sup> For a brief overview of different definitions of corruption see: N. Kogan, 'Thinking about corruption', *Transitions*, 3, 1998, pp. 40-45; M. Johnston, 'The search for definitions. The vitality of politics and the issue of corruption', *International Social Science Journal*, 149, September 1996, pp. 321-335.

<sup>3</sup> D. Granick, *The red executive. A study of the organization man in Soviet industry*, New York, 1969, p. 43.

<sup>4</sup> On corruption in the Soviet economy, see for example: W. A. Clark, *Crime and punishment in Soviet officialdom*, New York and London, 1993, pp. 71-99; N. Lampert, *Whistleblowing in the Soviet Union*, London, 1985, pp. 13-60; Alec Nove, *The Soviet Economic System*, London, 1977, S. 13-60; K. Simis, *USSR: secrets of a corrupt society*, London, 1982. The case of *blat*, a special kind of network between ordinary people, has not been considered here. The standard work on *blat* is: A. Ledeneva, *Russia's economy of favours*, Cambridge, 1998.

structures is no longer necessary to reach that aim.<sup>5</sup>

Harter names three fundamental changes in the nature of networks as result of post-Soviet developments:

Firstly, money plays an increasingly important role. A fact which leads to a monetarisation of transactions. This was not the case in the planned economy, since in a shortage economy goods are not available through formal channels, independent of available financial means. With the liberalisation of foreign trade and private business activities this restriction is no longer in place. Secondly, enterprises increasingly need to integrate into the regional economy (which was not necessary in the centralised planned economy) and they have to develop new contacts on their own. Thirdly, new networks are developing and new members are being included into old networks.<sup>6</sup>

In short, Russian enterprises still rely on informal networks that include the relevant branch ministries and related state institutions as well as suppliers and customers of the enterprises. The latter are included to maintain business relations under the conditions of the post-Soviet crisis. Networks facilitate barter transactions, which are currently the dominant form of payment in many branches. Networks are also used to obtain information. State institutions are included into these networks in order to secure support from the state. This support can have a number of different forms, ranging from direct subsidies to state orders and from tax breaks to a protectionist trade policy. Networks that are used by member enterprises to obtain state support with the help of corrupt contacts to state officials will, in the following sections, be referred to as corruption networks.

### *Corruption Networks and Rent-Seeking*

If an enterprise does not engage in market-oriented business activities, but concentrates instead on the development of good relations with the state in order to receive preferential treatment, its behaviour is defined as rent-seeking. Rent-seeking has a negative impact on the country's overall economic performance. Above all, the allocative efficiency of the market is weakened. Badly managed enterprises may survive on account of good connections with state officials, while efficient enterprises with few connections are eliminated through bureaucratic arbitrariness. As a result, innovation and growth processes are slowed down. Secondly, rent-seeking puts a heavy financial strain on the state budget. When the state offers financial support to inefficient enterprises,

<sup>5</sup> L. Holmes, 'Corruption and the crisis of the post-communist state', *Crime, Law & Social Change*, 3-4, 1997, pp. 275-97.

<sup>6</sup> S. Harter, *Wirtschaftliche Transformation in Russland. Ein Netzwerkansatz*, Osteuropa-Institut Berlin, 1997, pp. 20-21.



pays exorbitant bills for the fulfilment of state orders or privatizes enterprises for less than their actual values, the situation of the state budget deteriorates.

Nevertheless, a government can decide to accept rent-seeking as the lesser evil in cases where the market is thought to be unable to provide a desired good.<sup>7</sup> This is, for example, quite often the case with aid from food imports. The resulting protection of domestic agriculture through regulations and subsidies leads to rent-seeking behaviour on the part of farmers and the food industry. In such cases the responsible government clearly defines the areas for rent-seeking and tries to apply strict rules intended to minimize distorting effects; rent-seeking is mainly based on lobbying, not on corruption.

In societies with widespread corruption, a different situation arises. Both the political decisions of the government and the arbitrariness of a bureaucrat can lay the ground for rent-seeking. When laws and regulations leave considerable competence to bureaucrats, they can independently create the conditions for rent-seeking. Such activities increase and privileges are more often granted to individual enterprises than to certain branches of the economy. In the resulting rent-seeking society, every enterprise with good connections has a chance to obtain privileges from the state.<sup>8</sup> This means that whereas rent-seeking is not necessarily based on corruption, the existence of corruption networks allows for the uncontrolled spread of rent-seeking activities. This point shall be examined in more detail with the help of case studies of the Russian banking sector, the Russian coal industry and the Russian oil industry.

### *Corruption Networks in the Russian Banking Sector*<sup>9</sup>

One of the major roots of post-Soviet corruption networks in the Russian banking sector lies in the Soviet banking system, since the Soviet banks, or their branches, were simply transformed into private banks. Additional banks were created from state structures by transforming the financial departments of branch ministries into private banks. To a large degree, the management of such banks was composed of former employees of the respective ministry. These banks continued to service the financial needs of a specific branch of industry and they maintained close connections with state structures.<sup>10</sup>

<sup>7</sup> It is another question, how convincing the arguments in favour of such a decision are.

<sup>8</sup> A standard work on this topic is: J. Buchanan, *et al.* (eds.), *Toward a theory of the rent-seeking society*, 1980.

<sup>9</sup> A more detailed description can be found in: H. Pleines, 'Large-scale corruption and rent-seeking in the Russian banking sector', in A. Ledeneva, M. Kurkchyan (ed.), *Economic crime in Russia*, The Hague, *in print*.

<sup>10</sup> For a good overview of the development of the state banking sector see: J. E. Johnson, 'The Russian banking system. Institutional responses to the market

Another group of Russia's large banks was created more or less independently from state structures. Owing to private entrepreneurship a considerable number of private banks emerged. Up until 1995 the number of registered Russian banks exceeded 2,500. But most of these banks had negligible assets, and already in 1995 a quarter of them operated at a loss.<sup>11</sup> The fifty biggest banks, on the other hand, accounted for nearly half of all assets in the Russian banking sector.<sup>12</sup>

To condense, one may say that the Russian banking elite consists of two groups. The first group emerged from the Soviet *nomenklatura* and holds leading positions in those banks run, or at least previously run, by the state. The second of these elite groups was formed by the owners and managers of the big private banks.

The relevance of the first group is revealed by the fact that many post-Soviet bankers were holding influential Party posts in Soviet times. On a scale from one (Party secretary at the local level) to ten (Party secretary in the Central Committee), the banking elite gets an average of eight. Many members of the post-Soviet banking elite had been employed previously in the Soviet economic administration. A quarter was employed by Gosbank, the Soviet Central Bank.

The leadership of the large private banks, on the other hand, comprises of hardly any members of the former Soviet *nomenklatura*. The main reason for that is the low age of this part of the banking elite. They account for the nearly thirty per cent of leading bankers less than forty years old and, accordingly, they were still at university in the 1980s and only just started their careers at the time of Gorbachev's economic reforms.<sup>13</sup> Nevertheless, this new group of private bankers was smoothly integrated into networks between the banking sector and state officials. Large banks and the state were dependent on each other. The state as a customer, as an emitter of bonds and as the regulating and controlling body is of major importance to large banks. In turn, the state needed large banks to finance its budget deficit and to stabilize financial markets.<sup>14</sup>

In the Russian context, contacts between bankers and state officials

<sup>11</sup> transition', *Europe-Asia Studies*, 6, 1994, pp. 971-95.

<sup>12</sup> *Kommersant* daily, 14 July 1995, p. 5.

<sup>13</sup> The share of the ten biggest banks stood at thirty per cent. Calculations are based on the *Interfax-rating of Russian banks* (as of 1 September 1996).

All data according to: D. Lane, 'The Russian oil elite. Background and outlook', in Lane (ed.), *The political economy of Russian oil*, Boulder/Oxford 1999, pp. 75-96.

<sup>14</sup> The data are based on a survey of 118 leading business people of the Russian banking and finance sector, who were identified with the help of expert rankings of 'most influential businesspeople' in 1996 and 1997.

For an elaboration of this point see: K. F. Moors, *Russian banking. An overview and assessment* Washington, 1996 [Donald W. Treadgold Papers].



were, in many cases, transformed into corruption networks. When making decisions on licenses, credits, the sale of government bonds or the authorization of banks to deal with state funds, state employees had a considerable latitude which allowed them to get into 'negotiations' with individual banks in order to get bribed. In turn, the banks could help state officials and politicians to conceal illegal income for transfers abroad. Thanks to their control over the important mass media and because of their ability to provide funding for election campaigns, banks were also valued by politicians as contributing to their ability to stay in power.<sup>15</sup>

Whereas the credit business with enterprises was risky and not very profitable, business with the Russian state offered promising opportunities. For a long time Russia's big commercial banks have always been able to find a new form of rent-seeking when an old one becomes less profitable. In the phase of hyperinflation, 1992-94, they had made profits with the help of cheap Central Bank credits. After macroeconomic stabilization, the state offered them new opportunities at the bond market and with the authorization to handle state budget funds. Moreover, some banks got the chance for 'unbelievable bargains' in the privatization process.

Rent-seeking in the Russian bond market was based on special auctions of short-term treasury bills (GKOs). In 1995 and 1996, the average real interest rate of these GKOs exceeded 100 per cent per annum. Such extraordinary yields were not simply a risk premium in the emerging Russian market but a result of the fact that only a limited number of banks were allowed to participate in GKO auctions. The state, thereby, deliberately limited the demand for its treasury bills and accepted the resulting higher interest payments. In Summer 1996, the annual yield of GKOs after inflation rose above 150 per cent. This has been interpreted as a sort of compensation payment to those banks that had helped to finance the election campaign of President Yeltsin. Later that summer, when all restrictions on the GKO market had been lifted, yields fell sharply.<sup>16</sup> In 1997, GKO yields after inflation never exceeded thirty per cent. In July 1998, shortly before the Russian government defaulted on GKO payments, GKOs with a face value of USD seventy billion were in circulation issued to cover in total<sup>17</sup> a primary budget deficit of only USD

fifteen billion. Accordingly, the buyers of GKOs received USD fifty-five billion in interest payments in the period from 1994 to Summer 1998.<sup>18</sup>

Another main source of large-scale corruption in the banking sector was the system of 'authorized banks'. From 1994 to 1997 the Russian government annually authorized about fifty to 100 banks to manage state funds. Instead of demanding interest payments for the money deposited, the state often paid a fee for banking services. By delaying payments, the banks, in fact, received interest-free short-term credits from the state. In addition, the extremely limited control over the handling of state funds by private banks offered these banks and collaborating state officials opportunities for embezzlement.

The privatization auctions of 1995 mark the most scandalous rent-seeking success of Russian banks. A group of Russian banks offered the government a credit of about nine billion roubles (at that time about USD two billion) for financing the budget deficit. As collateral, the banks demanded that control over shares in a number of enterprises be passed to the banks. The shares were to be offered in a number of privatization auctions (loans-for-shares auctions) to the banks that had made the highest bid. If the state would not repay the credit, the banks would keep the shares as compensation. In that case, the state would have the right to demand the sale of the shares within three years and would receive a part of the selling price.

The rules for the auctions, as set out in a presidential decree,<sup>19</sup> had a number of weak spots that offered corruption networks possibilities for manipulations. An important point was that for each auction, a bank was appointed as co-organizer. If that bank was itself interested in acquiring the shares to be auctioned, it made a bid just above the required minimum and disqualified all rival bidders with a higher offer.<sup>20</sup> Consequently, most auctions were won by the bank participating in the auction's organization. In none of these cases did the loan offered exceed the minimum bid by more than fifteen per cent. If the bank responsible for collecting offers was not interested in the shares to be auctioned, other bidders had a chance. Since foreign investors were not allowed to take part, the number of potential bidders was rather small. The normal outcome of such a situation was an auction in which only two or more subsidiaries of one and the same Russian bank participated, all offering bids

<sup>15</sup> A. Fadin, 'The oligarchs in charge of "Russia Inc."', *Transition (OMIR)*, 4 April 1997, pp. 28-30; J. Johnson, 'Russia's emerging Financial-Industrial Groups', *Post-Soviet Affairs*, 4, 1997, pp. 333-65 (here: pp. 348-54); N. Lapina, *Die Wirtschaftsentwicklung im Kräftefeld der russlandischen Politik*, Köln, 1997 [Bericht des BföSt], pp. 12-13.

<sup>16</sup> A. Ashund, 'Russian banking. Crisis or rent-seeking?', *Post-Soviet Geography*, 8, 1996, pp. 495-502 (here: p. 497); R. Lyle, 'Banking shake-out expected to thin ranks of Russian banks', *RFE/RL Weekly Magazine*, 22 August 1996.

<sup>17</sup> This total is for the period 1994-97.

<sup>18</sup> Figures according to *Russian Economic Trends*, Monthly Update, September 1998.

<sup>19</sup> Philip Hanson made this point at the 1999 BASES annual conference. Presidential decree No. 889 (31 August 1995), 'O poriadke petredachi v 1995 godu v zalog aktsii nakhodivshiasia v federal'noi sobstvennosti', (*Sobornoe zakonodatel'stvo RF* 36, 1995, St. 3527).

<sup>20</sup> I. Gorstis, 'Oil industry privatisation, Russian style', *Petroleum Economist*, 2, 1996, pp. 3-4; N. Kalininchenko, et al., 'Vygodnochnaya pokupka sroditel', *Ekspert*, 17, 1995, pp. 41-45; A. Privalov, A. Chernakov, 'Chto pokazala vskrytie', *Ekspert*, 15, 1995, pp. 20-26.



just above the required minimum. Only two auctions saw real competition and successful offers considerably above the necessary minimum bid. By the end of 1998, all stakes had been bought by the banks that had received them as collateral.<sup>21</sup>

At that time, however, Russia's financial crisis, which culminated in August 1998, had already caused a fundamental change in the relationship between the state and banks. As a result of the crisis, many private banks became insolvent and are now in desperate need of state support in order to survive. Accordingly, the balance in the relationship has changed in favour of the state. Moreover, the relationship is losing importance since banks have become less powerful, and both state and banks have less to offer one another. Nevertheless, many commercial banks still consider rent-seeking with the help of corruption networks to be the most promising business strategy. Networks can influence the decision on the basis of which a bank can receive the necessary state support to avoid bankruptcy. Until March 1999, credits worth \$365 million had actually been granted, but the Central Bank had still not commented on any rules regulating its decisions.<sup>22</sup>

### *Corruption Networks in the Russian Coal Industry*

The production units of the coal industry, supervised by the Ministry for the Coal Industry in Soviet times, were transformed into joint-stock companies between 1992 and 1995. However, the majority of coal enterprises remained under state ownership and became incorporated into the state holding Rosugol, which was supervised by the Russian Ministry of Energy.<sup>23</sup> In its general structure, Rosugol was very much similar to the Soviet branch ministry. Accordingly, many old networks that regulated supplies for and deliveries of coal enterprises, remained in place. Since the coal industry was especially hard hit by the non-payment crisis, most transactions were still being made on a non-monetary basis.<sup>24</sup>

However, the networks between directors of coal enterprises and state officials at Rosugol found a new field of activity in 1996, when the World Bank offered Russia a loan worth \$500 million to support restructuring of the coal industry. The loan was meant to finance the closure of unprofitable mines

and measures to mitigate the social consequences. The World Bank funds, like other state subsidies for the coal industry, were to be distributed from the state budget through Rosugol and regional production associations to the coal enterprises. In this process, nearly half of the World Bank money disappeared.<sup>25</sup>

As a result of mounting accusations of corruption that jeopardized further support from the World Bank, Rosugol was dissolved in December 1997. All subsidies for the coal industry, including financial support from the World Bank, were now to be transferred directly from the state budget to the relevant enterprise.<sup>26</sup> In this manner, two layers of the coal industry's corruption networks disappeared. The networks now included state officials at the energy ministry, directors of coal enterprises and regional coal traders.

These traders, so-called middlemen, are at the core of schemes to embezzle funds from enterprises for the private use of network members. Most of these schemes are based on asset stripping in the form of underpricing. The coal enterprise sells the coal to the trader for cheaply – normally at a price far below production costs. The trader sells the coal at the regular market price and makes an immense profit that he subsequently shares with the enterprise director personally. As a result, the coal enterprise is working at loss – or considering the poor state of most coal enterprises, at a loss much bigger than necessary. Since the coal enterprises belong to the state, the state budget has to cover these losses.<sup>27</sup>

Collaboration with the relevant state officials helps to avoid investigations into the enterprise's finances and state subsidies are transferred to the enterprise. In many cases, enterprise directors have incited workers' protests against the government in order to demand additional subsidies for their enterprise. Thus, directors were able to put the blame for their company's poor financial state on the government, diluting attention from their own responsibility.<sup>28</sup>

Until mid-1998, more than USD 300 million embezzled in the coal industry had been detected by the federal tax authorities.<sup>29</sup> A special federal commission investigating cases in the Kuzbass, Russia's most important coal

<sup>21</sup> *Kommerstant*, 16 December 1998, p. 7. For more detailed information see: *Russian*

*Economic Trends*, 4, 1998, p. 44.

<sup>22</sup> *Reuters*, 5 March 1999.

<sup>23</sup> In 1999 state owned enterprises still accounted for about ninety per cent of Russia's coal production.

<sup>24</sup> Institut sravnitel'nykh issledovanii trudovykh otnoshenii (ISITO), Kemerovskii filial: Struktura upravleniia ugoi'noi promyshlennosti, Kemerovo, 1996 (internet version: <http://www.csv.warwick.ac.uk/fac/soc/complabstuds-coalres.doc>).

<sup>25</sup> *Baltimore Sun*, 19 July 1998; *Nezavisimaya Gazeta*, 10 December 1998, p. 4; J.

Pereira, 'Hard times in the Donbass', *FT Energy Economist*, 12, 1998, pp. 16–20.

<sup>26</sup> V. Leksin, L. Plakhtina, A. Shvetsov, 'Finansirovanie sotsial'noi infrastruktury skhershskikh gorodov', *Cheloviek i trud*, 8, 1998, pp. 31–36.

<sup>27</sup> S. Petukhov, 'Chernyi aysberg', *Ekspert* 16 November 1998, pp. 52–53; Matt Taibbi,

'Let them eat coal', *the eXile*, 5 July 1998 [distributed on Johnson's Russia List 6 July 1998].

<sup>28</sup> P. Biznyukov, 'Upravlenchieskie oshibki kak ugroza gosudarstvennoi bezopasnosti', *Eko*, 9, 1997, pp. 131–39.

<sup>29</sup> *Moscow Times*, 11 July 1998.



mining region, documented the criminalization of the branch in autumn 1998.<sup>30</sup> However, at that time, the Kemerovo governor (the *oblast'* in which the Kuzbass is located) initiated a serious effort to increase control over the management of coal enterprises<sup>31</sup> and to eliminate shady coal trading companies. With part of the responsibility for the coal industry transferred from the federal ministry to the regional administration, with increased control over the company management and with the attack on shady trading companies, the influence of corruption networks in the regional coal industry has been decisively weakened.<sup>32</sup>

### *Corruption Networks in the Russian Oil Industry*<sup>33</sup>

Out of the enterprises governed by the Soviet Ministry for the Oil Industry, a dozen major oil companies were founded between 1992 and 1995. Only in three of them does the state still hold a majority stake. As a result, the original post-Soviet oil elite consisted of the top managers of the leading oil producing companies and of the financial structures they had founded. 'Most of these people have maintained personal working and business contacts with each other for many years. That is why in recent years the oil elite has been able to rally in defence of its common economic interests.'<sup>34</sup> However, old connections between oil elite and state are not as close as in the case of the banking sector or the coal industry. On a scale from one (Party secretary at the local level) to ten (Party secretary in the Central Committee), the oil elite gets an average of four compared to eight for the banking elite. Among the members of the post-Soviet oil elite, twenty-nine per cent had earlier held a position in the Soviet economic administration compared to fifty-six per cent in the case of the banking elite.<sup>35</sup>

<sup>30</sup> Petukhov, 'Chernovo isberg', pp. 52-53.

<sup>31</sup> In January 1999 the federal government agreed that members of the regional administration will represent the state at the company boards of Kuzbass coal enterprises.

<sup>32</sup> H. Pleines, 'Down, out and forever desperate? The role of coal miners' protests in Russian politics', in S. Harter, G. Easter (eds.), *Shaping the economic space in Russia*, Aldershot, forthcoming.

<sup>33</sup> A more detailed description can be found in: H. Pleines, 'Corruption and crime in the Russian oil industry', in D. Lane (ed.), *The political economy of Russian oil*, Boulder, CO/Oxford 1999, pp. 97-110.

<sup>34</sup> Y. Pape, 'Fuel and energy complex elites in the political economy of contemporary Russia', in K. Segeters, S. de Spiegeler (eds.), *Post-Soviet Puzzles*, vol. III, Baden-Baden, 1995, pp. 459-77 (here: 468).

<sup>35</sup> All data according to: D. Lane, 'The Russian oil elite: Background and outlook', in D. Lane (ed.), *The political economy of Russian oil*, Boulder, CO/Oxford 1999, pp. 75-96. The data are based on a survey of fifty-five leading business people in the

Nevertheless, the oil industry can count on support from the state because of its special relevance for the Russian economy; it makes an important contribution to the country's gross domestic product and it has a potential to earn considerable profits. The government wants to ensure further tax and customs payments to the federal budget. A recovery of the oil industry would also be an important step towards solving the non-payment crisis and promoting general economic growth. The communist and nationalist fractions in the Russian parliament pay special attention to the oil industry, primarily in order to avoid a 'sell-out' to Western interests.

It must also be said that many state officials are much more interested in obtaining personal profits from the business operations of the oil industry. Thus,

the interests of government agencies and officials are best served not by laws which outline their powers and responsibilities in a very precise way, but by a system in which they enjoy as much freedom as possible to enter into "negotiations" with individual clients, to request certain kickbacks and bribes in return for particular favours. [...] It was not in the interests of government officials for a law to be passed which would clarify the industry's regulatory structure, and thus reduce their opportunities to extract personal gain.<sup>36</sup>

The relevant state officials, at the federal as well as at the regional level, formed corruption networks with the oil elite that allowed both groups to redirect some of the industry's profits into their own pockets. Since governing the oil industry promised a high additional income from bribes, many state institutions tried to become involved in decisions concerning the industry. In 1996, altogether fifteen different federal state bodies as well as the governments of Russia's regions, were responsible for reforms in the oil sector.<sup>37</sup> The number of state bodies responsible for administration and taxation of the oil industry is even higher.

A good example of the resulting 'intertwined network of mutual favours' was the system of oil co-ordinators. The interministerial commission assigned oil companies and exporters to be co-ordinators of oil ports and foreign markets. The commission reportedly based its decision upon the oil companies' expressed interests:

The coordinators assist in deciding who will export oil to which destination

<sup>36</sup> oil industry, who were identified with the help of expert rankings of 'most influential businesspeople' in 1996 and 1997.

<sup>37</sup> J. Watson, 'Foreign investment in Russia. The case of the oil industry', *Europe-Asia Studies* 3, 1996, pp. 429-55 (here: 447).

C. P. McPherson, 'Political reforms in the Russian oil sector', *Finance and Development (World Bank)* 2, 1996, table 1.



and how much, they too must approve the quarterly schedule. The coordinators also regulate the tanker schedules and loading at pipeline sea port terminals [...] Evidently, the oil companies benefit financially from their coordinating role, and it gives them the means to disadvantage their competitors or punish companies with whose actions they disagree.<sup>38</sup>

On the regional level, the Republic of Komi in Russia's Far North provides a good example of comprehensive corruption networks in the oil industry. Investigative journalists revealed in Spring 1999 that the republic's political leadership and the management of the regional oil company Kominetfi had embezzled more than USD ten million from oil exports with the help of a single scheme. In similar cases, further funds had been moved to Western companies and bank accounts.<sup>39</sup>

The most important activity of corruption networks was oil smuggling. Since it was much more profitable for a Russian oil company to export oil than to sell it in Russia, where prices are lower and customers are often unable to pay, the foreign trade regime led to widespread fraud. Furthermore, it should be noted that the foreign trade regime was designed in a way which allowed individual state officials to cover up smuggling activities. About a dozen competing bureaucracies had power over customs and new regulations were frequently amended. As a result, Russian customs regulations were incomplete and sometimes even contradictory. The opportunity and conditions under which oil could leave the country was to a great extent dependent on the state official concerned.<sup>40</sup>

Moreover, quotas for oil exports were often granted to regional authorities that had no experience with oil exports. This offered oil exporters the chance to be commissioned to organize the sale of the oil on behalf of the authorities. Sometimes the oil exporting company simply disappeared after the delivery.<sup>41</sup> Yet often oil exporters collaborated with the regional authorities and both made illegal profits.<sup>42</sup>

<sup>38</sup> US Embassy, Moscow, 'A primer on pipeline access and its politics in Russia', *Pipeline News*, 66, 5-11 July 1997. Although the Russian president Boris Yeltsin announced the liquidation of the system in his 1998 State of the Nation message, pipeline access remains subject to negotiations between state officials, the state-owned pipeline operator Transneft and oil companies.

<sup>39</sup> *EWI Russian Regional Report*, 25 March 1999.

<sup>40</sup> D. N. Baktrach, 'Tamozhennoe pravo kak institut administrativnogo prava', *Gosudarstvo i pravo*, 3, 1995, pp. 13-21; B. N. Gabrichidze, N. A. Suslov,

'Tamozhennye organy Rossijskoi Federatsii', *Gosudarstvo i pravo*, 3, 1995, pp. 22-29; B. V. Volzhenkin, *Ekonomicheskie prestuplenia*, St. Petersburg 1999, pp. 179-222.

<sup>41</sup> *Izvestiya*, 4 January 1997.

<sup>42</sup> For example, see: H. Pleines, 'Organized crime and corruption in Russia since 1987',

The Russian oil industry also engaged in illegal capital flight, firstly to launder illegal profits from oil smuggling, and secondly to invest legal profits abroad in order to find better investment opportunities and avoid taxation in Russia. Tikhonov has estimated that capital flight from the Russian oil industry amounted to a total of \$7.4 billion in the period from 1992 to 1995.<sup>43</sup> The criminalization of foreign trade in combination with heavy pressure from the International Monetary Fund caused the Russian government gradually to liberalize the prices and the foreign trade policy with respect to oil. Most of the shady oil exporting companies have left the market.

The drastic decline in profits from illegal activities led to a decriminalization of the Russian oil industry. However, the corruption network of the oil industry will remain in place, as good connections with the state will continue to be vital for the Russian oil business. They still offer preferred access to export capacities and preferential treatment by the tax authorities.

### Conclusion

Soviet corruption networks, formed between enterprise directors and relevant state officials, have in many cases survived the end of the Soviet Union. These networks have included new enterprises, as was the case with newly founded private banks, and they have also integrated new groups with a new function like the shady coal traders.

According to their relationship with the state, two types of post-Soviet corruption networks can be distinguished. Aggressive networks receive most of their income from rent-seeking activities. The member enterprises need state funds to survive economically. This is evidently the case with the coal industry, but it is also largely true of the banking sector. The networks of the oil industry, however, are defensive. They do not use corruption to increase possibilities for rent-seeking but to defend their business activities from state interference (e.g. in the form of export quotas) and to minimize transfers to the state budget (i.e. through tax and tariff payments).

It is a general problem of defensive networks that they must integrate a considerable number of state agencies. As every agency is interested in transfers from profitable businesses, they are all trying to acquire responsibility for the relevant branch. As a result, more than twenty state agencies have selected rights over regulation or control in the oil industry. In order to avoid bureaucratic obstacles and to reduce payments to the state budget, most of them have to be included into corruption networks. Aggressive networks, on the

<sup>43</sup> *Russia & the Successor States Briefing Service*, 5, 1995, pp. 3-20 (here: p. 9).

V. Tikhonov, 'Capital flight from post-Soviet Russia', *Europe-Asia Studies*, 4, 1997, pp. 591-615 (here: table 3).



other hand, only need to include those state agencies, which are of relevance for their rent-seeking activities, such as the relevant part of the Ministry of Energy in the case of the coal industry, and the Ministry of Finance plus the central bank in the case of the banking sector.

In each branch, a number of rivaling networks exist. This is due to the fact that the networks are supporting individual enterprises, instead of lobbying for the general interests of a branch. Subsidies paid to one coal enterprise cannot be paid to the others. Export quotas granted to one oil company reduce the capacity available for the remaining companies. That these rivalries between different corruption networks can lead to open conflict has been demonstrated by the 'war of the banks' 1995-97, when different networks publicly accused each other of corruption and fraud in the privatization process.<sup>44</sup>

In addition, it should be noted that the post-Soviet corruption networks are not all-encompassing. There are not only rivaling networks but also companies not belonging to any network. In branches dominated by such networks, these unattached companies are the likely losers. In the banking sector altogether more than 3,000 enterprises were founded until 1998. The vast majority of them never gained access to any relevant network and were liquidated as soon as they encountered financial difficulties. In the coal industry, those mines that are being closed down do not enjoy the support of the relevant state officials at the Ministry of Energy. Moreover, there are sincere enterprise directors who do not engage in fraudulent schemes and who are, therefore, less reliant on corruption networks. In the oil industry, the most obvious outsiders are foreign investors who have, in most cases, failed to enter the Russian oil industry successfully.

Not only these more honest business suffer from the activities of corruption networks but society as a whole does. Relevant negative consequences of corruption are<sup>45</sup>:

*Negative overall economic effect.* Whereas a single company can reduce its transaction costs through corruption, widespread corruption leads to an increase in transaction costs at the national level. A single company can, for example, profit from offering a bribe to a judge. Still, the resulting legal uncertainty considerably hampers the overall economic development. Bribe payments to avoid taxation will increase the company's profits, but the resulting

<sup>44</sup> J. Johnson, 'Russia's emerging Financial-Industrial Groups', *Post-Soviet Affairs*, 4, 1997, pp. 333-65 (here: pp. 355-57).

<sup>45</sup> For general assessments of the effects of wide-spread corruption see for example: P. Keefer, Stephen Knack, 'Why don't poor countries catch up?', *Economic Inquiry*, 1997, pp. 590-602; Daniel Kaufmann, 'Corruption. The facts', *Foreign Policy*, 1997, pp. 114-131; Vito Tanzi, Hamid Dawoodi, 'Corruption, public investment, and growth', *IMF Working Paper* 97, 139, Washington, 1997.

state budget deficit reflects macroeconomic consequences. Moreover, corruption networks between managers and state officials prevent competition in many markets. Companies turn to the state for support instead of adopting market-oriented behaviour. In the case of widespread corruption political decision-makers lose control of this rent-seeking, since corrupt state officials multiply the possibilities.

*Criminalization.* After the end of state repression, corruption has also led to the spread of organized crime. Only corruption offers protection from criminal prosecution, and thus allows for the persistence of criminal behaviour on a large scale. Russian efforts to fight this criminalization have been slow and at best half-hearted. This fact can only be explained by the high level of corruption among state officials and the tight connections between criminals and state. As a result of this situation state officials receive money for offering all kinds of 'preferential treatment'. Police forces, custom authorities and other investigative bodies are paid to cover up criminal activities.

*Anti-democratic effect.* Widespread corruption makes democratic decision-finding impossible, since politicians are regularly 'bought'. The rule of law, too, is weakened, since laws can be overruled with the help of corruption. The extensive media coverage of cases of corruption, which started with the liberalization of the media system, discredits the political leadership and its policy of reforms and it spoils the image of business people. One likely effect in the economic sphere is a decline in foreign investment and a reduction of international financial support.

*Distributive effect.* On the grounds of corruption, some businessmen had the possibility to make immense profits in the privatization process and with foreign trade activities. At the same time, some state officials could increase their real income considerably through corruption.

Looking at the negative consequences of corruption, the question that has often been asked is why the relevant political leaderships do nothing, or at least not enough, to fight corruption. The classical answer, often given for Russia too, sees corruption as a typical principal-agent problem. In this view, sensible government rules and serious anti-corruption efforts are being perverted by corrupt bureaucrats. Since it is in most cases impossible to replace the whole corrupt bureaucracy and to establish uncorrupt practices as the norm in people's minds, attempts to root out corruption have little chance to be successful.

However, in the Russian case, like in many cases of societies with widespread corruption and powerful corruption networks, it must be questioned whether the political leadership is really interested in rooting out corruption in the first place. Charap and Harn<sup>46</sup> have argued that the political leadership of

<sup>46</sup> J. Charap, C. Harn, 'Institutionalized corruption and the kleptocratic state', *IMF*



many countries uses corruption in order to incorporate a powerful bureaucracy into the political system. Firstly, corruption offers the bureaucracy an attractive source of additional income. Secondly, corruption provides a hostage mechanism that effectively constrains bureaucrats – due to their own participation – from turning to the public to denounce the system. At the same time, the political leadership always has the possibility to get rid of a certain bureaucrat by proving that he has been engaged in corruption.

Of course, it is difficult to prove that Russia's political leadership, grouped around President Yeltsin until the end of 1999, has permanently and knowingly supported the rise of corruption networks, like those analyzed above, in order to incorporate the powerful Soviet bureaucracy into the new post-Soviet system. However, it is rather obvious that from time to time Russia's political leadership has found these side-effects of corruption rather helpful. Moreover, in a weak democracy like Russia there is another possible side-effect of corruption welcomed by the political leadership:

A weak democracy typically features meaningful constitutional protection of the citizenry against government sponsored rent-seeking for private gain, but nonetheless has weak political institutions. In this case, political rent-seeking may take on the form of what Bardhan labels political corruption: the use of corruption proceeds to maximize re-election chances, rather than the pursuit of rents solely for private consumption.<sup>47</sup>

This point, the financing of an election campaign with the help of funds gained through corruption networks, has often been seen as an explanation for Yeltsin's re-election in 1996.

To summarize, Russia's political leadership has profited in a number of ways from wide-spread corruption and especially from the existence of corruption networks in the Russian economy. This fact should have reduced the incentives of members of the political leadership to fight corruption. However, in order to give an overall account, it is necessary to conduct further case studies, including other branches and paying more attention to the role of state actors in corruption networks.

## Transformation and European Integration: The Developments in Estonian Foreign Trade and Business Structures<sup>1</sup>

TÕNU ROOLAHT

**ABSTRACT** The main goal of the paper is to discuss the changes in transformation process caused by ongoing European integration. A look will be taken at the developments in Estonian foreign trade patterns as well as at the modifications of industrial structures and enterprises that follow the requirements of transformations and integration. The analysis of the foreign trade patterns of Estonia in the 1990s should give valuable insights about repositioning in an East-West or Past-Future continuum in terms of main trade partners and their origin regions. The discussion of business level changes is aimed at the determination of problems and opportunities related to preparation for EU enlargement. In that respect two groups of firms are focused on: firms that have direct business contacts with European enterprises in the form of trade partnership, strategic co-operation or ownership relations; and firms that have domestic scale or are oriented on Eastern European markets. These groups are analyzed separately. Also some suggestions for the development of appropriate industrial policy will be given. Theoretical conclusions will be supported with empirical data analysis. Also regression analysis of certain integrational aspects is conducted.

### Introduction

THE PROCESS OF EUROPEAN Union (EU) enlargement to Eastern Europe has opened up a need for several important changes in the national legislations of the countries involved. This includes adjustment in their institutional structures to the norms and customs of the EU. The enlargement process entails changes not only in the governmental institutions but also in the business sector. The impact of this process can be described as direct or indirect. The effect of EU integration is direct, if enterprises under consideration have immediate relations with EU member countries, for example, in the spheres of subcontracting, export, equity participation or partnership. Conversely, firms operating within the domestic sector or those oriented towards non-members like Russia or Ukraine are affected indirectly.

<sup>47</sup> *Working Paper 99, 91*, Washington, 1999, pp. 14-18.  
*Ibid.*, p. 18.

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