A policy of mass destruction

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Czech privatisation voucher. Credit: Rios via Wikimedia Commons.

A new analysis showing how the radical policies advocated by western economists helped to bankrupt Russia and other former Soviet countries after the Cold War has been released by researchers.

The study, led by academics at the University of Cambridge, is the first to trace a direct link between the mass privatisation programmes adopted by several former Soviet states, and the economic failure and corruption that followed.

Devised principally by western economists, mass privatisation was a radical policy to privatise rapidly large parts of the economies of countries such as Russia during the early 1990s. the policy was pushed heavily by the International Monetary Fund, the World Bank and the European Bank for Reconstruction and Development (EBRD). Its aim was to guarantee a swift transition to capitalism, before Soviet sympathisers could seize back the reins of power.

Instead of the predicted economic boom, what followed in many ex-Communist countries was a severe recession, on a par with the Great Depression of the United States and Europe in the 1930s. The reasons for economic collapse and skyrocketing poverty in Eastern Europe, however, have never been fully understood. Nor have researchers been able to explain why this happened in some countries, like Russia, but not in others, such as Estonia.

Some economists argue that mass privatisation would have worked if it had been implemented even more rapidly and extensively. Conversely, others argue that although mass privatisation was the right policy, the initial conditions were not met to make it work well. Further still, some scholars suggest that the real problem had more to do with political reform.

Writing in the new, April issue of the American Sociological Review, Lawrence King and David Stuckler from the University of Cambridge and Patrick Hamm, from Harvard University, test for the first time the idea that implementing mass privatisation was linked to worsening economic outcomes, both for individual firms, and entire economies. The more faithfully countries adopted the policy, the more they endured economic crime, corruption and economic failure. This happened, the study argues, because the policy itself undermined the state's functioning and exposed swathes of the economy to corruption.

The report also carries a warning for the modern age: “Rapid and extensive privatisation is being promoted by some economists to resolve the current debt crises in the West and to help achieve reform in Middle Eastern and North African economies,” said King. “This paper shows that the most radical privatisation programme in history failed the countries it was meant to help. The lessons of unintended consequences in Russia suggest we should proceed with great caution when implementing untested economic reforms."

Mass privatisation was adopted in about half of former Communist countries after the Soviet Union's collapse. Sometimes known as "coupon privatisation", it involved distributing vouchers to ordinary citizens which could then be redeemed as shares in national enterprises. In practice, few people understood the policy and most were desperately poor, so they sold their vouchers as quickly as possible. In countries like Russia, this enabled profiteers to buy up shares and take over large parts of the new private sector.

The researchers argue that mass privatization failed for two main reasons. First, it undermined the state by removing its revenue base – the profits from state-owned enterprises that had existed under Soviet rule – and its ability to regulate the emerging market economy. Second, mass privatization created enterprises devoid of strategic ownership and guidance by opening them up to corrupt owners who stripped assets and failed to develop their firms. "The result was a vicious cycle of a failing state and economy," King said.

To test this hypothesis, King, Stuckler and Hamm compared the fortunes between 1990 and 2000 of 25 former Communist countries, among them states that mass-privatised and others that did not. World Bank survey data of managers from more than 3,500 firms in 24 post-communist countries was also examined.

The results show a direct and consistent link between mass privatisation, declining state fiscal revenues, and worse economic growth. Between 1990 and 2000, government spending was about 20% lower in mass privatising countries than in those which underwent a steadier form of change. This was the case even after the researchers adjusted for political reforms, other economic reforms, the presence of oil, and other initial transition conditions.

Similarly, mass privatising states experienced an average dip in GDP per capita more than 16% above that of non mass-privatising countries after the programme was implemented.

The analysis of individual firms revealed that among mass-privatising countries, firms privatised to domestic owners had greater risks of economic corruption. Private domestic companies in these countries were 78% more likely than state-owned companies to resort to barter rather than monetary transactions. This was revealed to be the case after the researchers had corrected the data for firm, market and sector characteristics, as well as the possibility that the worst performing firms were the ones privatised.

The study also revealed that such privatised firms were less likely to pay taxes – a critical factor in ensuring the failure of the policy, which western economists predicted would generate private wealth that could be taxed and ploughed back into the state. However, firms that were privatised to foreign owners were much less likely to engage in barter and accumulate tax arrears.

“Our analysis suggests that when designing economic reforms, especially aiming to develop the private sector, safeguarding government revenues and state capacity should be a priority,” the authors add. “Counting on a future burst of productivity from a restructured, private economy to compensate for declining revenues is a risky proposition.”

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